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CPA's guide to estate planning techniques for the closely-held business owner

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American Institute of Certified Public Accountants

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FOREWORD

This book provides information for accounts who are called upon to assist their clients, who are closely held business owners, with their estate plans. It is designed for experienced practitioners and emphasizes the integration of their clients' multifaceted situations so that they can take advantage of the available planning tools.

David Thomas, III, Esq. of Sherman & Howard, Denver, CO has written an informative and practical book.

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INTRODUCTION

This book should aid experienced practitioners who want to continue developing their expertise in estate planning, particularly as it relates clients who are owners of closely held businesses.

It first discusses the basic transfer tax rules and traditional planning with wills. Then the focus narrows to examine issues that particularly affect closely held businesses and their owners such as insurance planning, buy-sell agreements, gifting of closely held businesses and other related interests, and the book closes with sale and ownership considerations.

We will use these following case scenarios throughout the book to illustrate the concepts.

A. **Marvelous Masonry**

Mike and Mildred have a masonry business which generates approximately $3,250,000 of gross revenue each year. The business is organized as a C corporation called Marvelous Masonry Inc. The corporation owns the operating business, equipment and vehicles, the real estate and office building associated with the business, and a separate rental property. Mike and Mildred are each 56 years old. They have three children. Son, Tim, age 34 is beginning to assume control of the business. He is quite capable. Tim is married to Laura. Laura's parents are wealthy. Tim and Laura have two children. Mike and Mildred have two daughters, Ann and Barbara. Ann and Barbara are both married and live out of state. Ann and her husband are prosperous; they have one child. Barbara and her husband are of more modest means; they have three children. The business has a value of approximately $2,500,000. Mike and Mildred have other assets with an approximate value of $1,000,000.

B. **Plumbing Perfection**

Don and Patricia own a plumbing business. It generates approximately $650,000 of annual gross revenue. The business is organized as a C corporation. Don runs the business but there is also a key employee, Jack. Currently Jack is paid a salary. Don owns 100% of the stock of the C corporation. C corporation owns the operating business and equipment and vehicles. Don and Patty are 48 years old. They have three children, none of whom appear to be candidates to work in the business. Their main other asset is their residence.

C. **Spectacular Sod**

Jim and Jane own a sod farm. The sod farm is organized as an S corporation called Spectacular Sod, Inc. Jim is 75 years old; Jane is 69 years old. They have two sons, Will and Derrick, both of whom work in the business. Historically Jim has been the resourceful entrepreneur overseeing all aspects of the business. Jim's health is beginning to fail. Son Will oversees scheduling of the jobs and dispatching trucks, drivers, and sod. Son Derrick provides estimating and increasingly is overseeing financial and corporate aspects of the business. The family owns a number of tracts of real property including one now poised for development. The business earned profits last year of $950,000. The real estate has a value of $6,000,000 to $9,000,000.

Chapter 1

Transfer Tax Rules—Closely Held Business

FEDERAL ESTATE TAX

The liability for the payment of the estate tax is imposed upon the executor (also known as personal representative in many states) or administrator of the estate (IRC §2002). The taxable estate for estate tax purposes includes assets that are titled in the decedent's name, retirement plan benefits, life insurance and other interests. These include revocable transfers, transfers with a retained interest, joint tenancy property, community property, property subject to a general power of appointment, and certain transfers of interests made within three years of death.

FEDERAL ESTATE TAX RATES

The estate tax is paid with the filing of Form 706, the federal estate tax return. The tax is due nine months after the date of death. The rates are set forth in Table A.

TABLE A—Unified Rate Schedule

Column A Taxable amount over	Column B Taxable amount not over	Column C Tax on amount in Column A	Column D Rate of tax on excess over amount in Column A
			(Percent)
0	$10,000	0	18
$10,000	20,000	$1,800	20
20,000	40,000	3,800	22
40,000	60,000	8,200	24
60,000	80,000	13,000	26
80,000	100,000	18,200	28
100,000	150,000	23,800	30
150,000	250,000	38,800	32
250,000	500,000	70,800	34
500,000	750,000	155,800	37
750,000	1,000,000	248,300	39
1,000,000	1,250,000	345,800	41
1,250,000	1,500,000	448,300	43
1,500,000	2,000,000	555,800	45
2,000,000	2,500,000	780,800	49
2,500,000	3,000,000	1,025,800	53
3,000,000	. . . .	1,290,000	55

For estates between $10 million and $21,040,000, there is a 5% surcharge.

APPLICABLE CREDIT AMOUNT

The unified credit is increasing each year, ending in 2006. The applicable exemption amount corresponding to the increasing credit is set forth in Table B (§2010).

TABLE B

INCREASE IN APPLICABLE EXEMPTION AMOUNT (1997 STATUTORY CHANGE)	
1998	$ 625,000
1999	650,000
2000	675,000
2001	675,000
2002	700,000
2003	700,000
2004	850,000
2005	950,000
2006	1,000,000

MARITAL DEDUCTION

A deduction is allowed under IRC §2056 for the value of property that passes from the decedent to the decedent's surviving spouse. This is the unlimited marital deduction. This deduction applies to gifts which are made outright from the decedent to his spouse, as well as to certain interests transferred in trust for the benefit of the spouse during the spouse's lifetime within the limitations allowed under §2056. The spouse must be a U.S. citizen to qualify for an unlimited marital deduction.

OTHER DEDUCTIONS—CREDITS

Administrative Expenses

Under §2053 administrative expenses are a deduction for purposes of determining the amount of the taxable estate. The executor has to choose whether to take these deductions on the decedent's income tax return or on the federal estate tax return [refer to §642(g)].

Expenditures incurred in connection with the funeral and burial are deductible and include such items as casket, burial vault, clothing purchased for burial, flowers provided by the estate, and the cost of transporting the body to the place of burial. Tombstone monuments and mausoleum burial plots are also deductible. The expenses are limited by a test of reasonableness and whether or not they are properly allowable out of the probate estate under state law. Also, the expenses must actually have been paid from the decedent's estate in most cases.

Other deductible administrative expenses are the executor's commissions, attorney's and accountant's fees for the estate, and other expenses incurred in the collection of assets, payment of debts, and distribution of property to the persons entitled to it from the estate.

Debts

The estate may deduct from what would otherwise be the taxable estate claims which were personal obligations of the decedent which were enforceable against the decedent at the time of death. It may also include contingent claims against the decedent if there is a possibility that the liability will actually arise. In general, taxes are deductible in the estate to the extent that they were an enforceable obligation against the decedent at the time of death. Unpaid gift taxes on gifts made by the decedent before his death are deductible. (State death taxes and possibly some foreign taxes are credits against the federal estate tax.) Taxes on income earned by the decedent prior to death are deductible. This does not include income of the surviving spouse. Nor does it include taxes on income received after death. The estate may elect to treat state death taxes and some foreign taxes which are imposed upon charitable bequests as deductions.

Casualty Losses

The estate may deduct casualty losses incurred by the estate (IRC §2054). The type of casualties which may be deducted are those defined under IRC §165(c).

State Death Taxes

The federal estate tax is credited with the amount of any estate, inheritance, legacy, or succession taxes actually paid to any state, which does not exceed the statutory amounts (§2011). The credit may not exceed the amount determined under the following table [§2011(b)].

Many states impose a state estate tax which exactly equals the state death tax credit under the federal estate tax provisions. The effect is to allocate a fraction of the tax revenue to state government and to reduce the amount paid to the federal government, without increasing the amount of total tax on the decedent's estate. A few states impose estate taxes which exceed the federal credit. A few cities collect a transfer tax at death.

Charitable Deduction

An unlimited charitable deduction for property passing to a qualified charitable organization is allowed. The value of all bequests, legacies, devisees, devices, or transfers to or for the use of the United States, any state, any political subdivision for exclusively public purposes or to or for the use of any corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes is allowed as a deduction against the estate tax.

TABLE C

Computation of Maximum Credit for State Death Taxes (Based on Federal Adjusted Taxable Estate)

(1) Adjusted taxable estate equal to or more than —	(2) Adjusted taxable estate less than —	(3) Credit on amount in column (1)	(4) Rate of credit on excess over amount in column (1)	(1) Adjusted taxable estate equal to or more than —	(2) Adjusted taxable estate less than —	(3) Credit on amount in column (1)	(4) Rate of credit on excess over amount in column (1)
			(Percent)				(Percent)
0	$40,000	0	None	2,040,000	2,540,000	106,800	8.0
$40,000	90,000	0	0.8	2,540,000	3,040,000	146,800	8.8
90,000	140,000	$400	1.6	3,040,000	3,540,000	190,800	9.6
140,000	240,000	1,200	2.4	3,540,000	4,040,000	238,800	10.4
240,000	440,000	3,600	3.2	4,040,000	5,040,000	290,800	11.2
440,000	640,000	10,000	4.0	5,040,000	6,040,000	402,800	12.0
640,000	840,000	18,000	4.8	6,040,000	7,040,000	522,800	12.8
840,000	1,040,000	27,600	5.6	7,040,000	8,040,000	650,800	13.6
1,040,000	1,540,000	38,800	6.4	8,040,000	9,040,000	786,800	14.4
1,540,000	2,040,000	70,800	7.2	9,040,000	10,040,000	930,800	15.2
				10,040,000	....	1,082,800	16.0

VALUATION — SPECIAL USE

The owner of a closely held business may be able to reduce the value of real property for federal estate tax purposes, helping to protect the family business for the second generation. IRC §2032A provides for the "special use" evaluation of qualified real property.

SECTION 2032A

A farm, ranch, or closely held business may qualify for special use valuation under IRC §2032A if real property passes from the decedent to a qualified heir of the decedent and such property, on the date of the decedent's death, was being used for a qualified use by the decedent or a member of the decedent's family, but only if:

1. 50% or more of the adjusted value of the gross estate consists of the adjusted value of the real or personal property, which, on the date of the decedent's death, was being used for a qualified use by the decedent or a member of the decedent's family and passed to a qualified heir.

2. 25% or more of the adjusted value of the gross estate consists of the adjusted value of the real property.

3. During the eight-year period ending on the date of the decedent's death, there have been periods aggregating five years or more during which such real property was owned by the decedent or member of the decedent's family and used for a qualified use, and there was "material" participation by the decedent or member of the decedent's family in the operation of the farm or other business.

RECAPTURE

If within ten years after the decedent's death and before the death of the qualified heir, the qualified heir disposes of any interest in qualified real property (other than by a disposition to a member of his family) or the qualified heir ceases to use the qualified real property for its qualified use, there is imposed additional estate tax (recapture).

In effect, IRC §2032A permits the valuation of qualified real property use for farming purposes or in a trade or business on the basis of the property's value for *actual use* rather than on *its highest and best use*. The classic property in this regard is a farm just outside town, now in the path of development. The real property may have a substantially lesser value used as a farm than as a development tract.

LIMITATION

Notably, the total decrease in the value of all real property under §2032A may not exceed $760,000 for 1999. This amount is adjusted annually under §2032A(a)(3).

TEDIOUS REQUIREMENTS

Unfortunately, the legal work to determine qualification for §2032A special use valuation and the accounting/computational work constitutes a formidable burden. This opportunity to reduce the valuation of real property for federal estate tax purposes is by no means a "check the box" procedure. There must be careful computational analysis of the special use based on consideration of rents, crop prices and historic trends.

DEDUCTION — FAMILY–OWNED BUSINESS INTEREST

SECTION 2057

Section 2057 permits as a deduction from the value of the gross estate the adjusted value of qualified family-owned business interest (QFOB). This section applies to an estate if:

- The sum of the adjusted value of the qualified family-owned business interest plus the amount of the gifts of such interest exceed 50% of the adjusted gross estate, and
- During the eight-year period ending on the date of the decedent's death, there have been periods aggregating five years or more during which such interests were owned by the decedent or a member of the decedent's family, and there was material participation by the decedent or a member of the decedent's family in the operation of the family business.
- The qualified family business interests are included in the value of the gross estate and are acquired by any qualified heir or passed to any qualified heir from the decedent.
  - The term qualified family-owned business interest means an interest as a proprietor in a trade or business carried on as a proprietorship, or an interest in an entity carrying on as a trade or business if:
    - At least 50% of such entity is owned directly or indirectly by the decedent or member of the decedent's family,
    - 70% is solely owned by members of two families, or
    - 90% of such entity is owned by members of three families and at least 30% of such entity is solely owned by the decedent and members of the decedent's family.

For these purposes, the decedent is treated as engaged in a trade or business if any member of the decedent's family is engaged in such trade or business.

Recapture

As with §2032A, the deduction under §2057 is subject to recapture information. There is imposed an additional estate tax, if within ten years after the date of the decedent's death, and before the date of the qualified heir's death:

- The material participation requirements are not met, or
- The qualified heir disposes of any portion of the qualified family-owned business interest, or the qualified heir losses U.S. citizenship, or the principal place of business ceases to be located in the United States.

The amount of the additional estate tax is equal to the applicable percentage of the adjusted tax difference attributable to the qualified family-owned business, plus interest. For the purpose, the applicable percentage is as follows: If the recapture event occurs in the following year of material participation

1.	100%	7.	80%
2.	100%	8.	60%
3.	100%	9.	40%
4.	100%	10.	20%
5.	100%		
6.	100%		

Coordination With Unified Credit

The amount of the deduction under §2057 is coordinated with the Unified Credit so that together the protection equals $1,300,000. The maximum deduction under §2057 is $675,000. If the amount of the deduction is less than $675,000 then the unified credit exemption amount is increased (but not above the amount that would otherwise apply) by the excess of $675,000 over the amount of the deduction allowed.

DEFERRAL

Section 6166

Section 6166 provides for an extension of time for the payment of estate tax where the estate consists largely of an interest in a closely held business. If the value of the interest in a closely held business, which is included in the gross estate of the decedent, exceeds 35% of the adjusted gross estate, the executor may elect to pay part or all of the federal estate tax in two or more (but not exceeding 10) equal installments.

The maximum amount of tax which may be paid in installments under IRC §6166 shall be an amount which bears the same ratio to the federal estate tax as the closely held business amount bears to the amount of the adjusted gross estate.

Definition

The term "interest in a closely held business" means an interest as a proprietor in a trade or business carried out as a proprietorship, or an interest as a partner in a partnership if 20% or more of the total capital interest in such partnership is included in determining the gross estate of the decedent or such partnership had 15 or fewer partners, or stock in a corporation if 20% or more in value of the voting stock of such corporation is included in determining the value of the gross estate or if such corporation had 15 or fewer shareholders. The deferral is not available for passive assets.

Interest

If the time for payment of any amount of tax is extended under IRC §6166, the interest is payable.

Under prior law, §6601(j) provided a special 4% rate of interest on a certain portion of the estate tax on a closely held business if an executor elected to pay the tax in installments. This special low interest rate applied to the amount of deferred estate tax attributable to the first $1,000,000 in value of a closely held business only. The amount of estate tax payable in installments that exceeded the amount subject to the 4% rate was subject to interest at the IRC §6621 underpayment rate. This underpayment rate is the federal short-term rate plus three percentage points. In addition, the interest paid on the deferred payments was a deductible expense for estate or income tax purposes.

Beginning with the Taxpayer Relief Act of 1997, interest at the rate of 2% is imposed on the "2% portion," i.e., the first $1,000,000 in taxable value of the estate tax attributable to a closely held business when an estate elects the IRC §6166 extension of time for the payment of estate tax. In addition, the interest rate imposed on the amount of the deferred estate tax attributable to the taxable value of the closely held business in excess of the 2% portion is reduced to an amount equal to 45% of the rate applicable to underpayments of tax.

Notably, no deduction is allowed for estate tax or income tax purposes for the interest paid on estate taxes deferred under §6166 subsequent to the new law. Effective for estates of decedents dying after December 31, 1997.

Prior to the Taxpayer Relief Act of 1997, only a surviving spouse could rent specially valued property on a net cash basis without figuring the recapture tax. Now, however, lineal descendants of the decedent may lease specially valued real property to a member of the lineal descendant's family on a net cash basis without subjecting such individual to the recapture tax. The lineal descendant will not trigger recapture solely because the descendant rents such property to members of his family on a net cash basis.

VALUATION — MINORITY INTEREST

One of the mainstays of estate planning with a closely held business is to **discount** the value of the business interest for federal transfer tax purposes. Fractional interests are discounted from their pro rata share of enterprise value for two main reasons — minority status and lack of marketability.

IRS POSITIONS

Historically, the IRS was reluctant to accept discounts on interest in family businesses where the family as a unit held control. Generally, fractional interests held by members in the same family were combined for valuation purposes. However, the courts repeatedly ruled in favor of applying minority interest, as long as the standard of value was "fair market value" [see *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir., 1981) and *Propstra v. United States*, 680 F.2d 1248 (9th Cir., 1982)].

REV. RUL. 93–12

However, in Rev. Rul. 93-12, the IRS finally acquiesced to numerous court opinions. Rev. Rul. 93-12 is reproduced below.

ISSUE

If a donor transfers shares in a corporation to each of the donor's children, is the factor of corporate control in the family to be considered in valuing each transferred interest, for purposes of §2512 of the Internal Revenue Code?

P owned all of the single outstanding class of stock of X corporation. P transferred all of P's shares by making simultaneous gifts of 20% of the shares to each of P's five children, A, B, C, D, and E.

HOLDING

If a donor transfers shares in a corporation to each of the donor's children, the factor of corporate control in the family is not considered in valuing each transferred interest for purposes of §2512 of the Code. For estate and gift tax valuation purposes, the Service will follow *Bright, Propstra, Andrews,* and *Lee* in not assuming that all voting power held by family members may be aggregated for purposes of determining whether the transferred shares should be valued as part of a controlling interest. Consequently, a minority discount will not be disallowed solely because a transferred interest, when aggregated with interests held by family members, would be a part of a controlling interest. This would be the case whether the donor held 100% or some lesser percentage of the stock immediately before the gift.

It is notable that Rev. Rul. 93-12 does not accept discounts on partnership interests. Notwithstanding the IRS reluctance, case law has permitted discounts for a minority partnership interest and the discounts have expanded in recent years. The key case in this area was *Estate of Watts v. Commissioner*, 60 A.F.T.R. 2d 6117 (1987). In that case, the decedent died owning a 15% general partnership interest in a lumber production company. The partnership agreement contained a contractually imposed limitation on liquidation. Accordingly, the *Watts* court found that a straight asset valuation approach is not applicable for interests that cannot cause liquidation (like the 15% partnership interest of the decedent, and that partnership interests should be valued. The Court found that the appropriate discount for the general partnership interest was 35%. In addition, the *Watts* opinion incorporated a discussion of the lack of marketability as a factor in establishing the magnitude of the appropriate discount. [See also *Estate of Harrison v. Commissioner*, 42 T.C.M. 1306 (1987) in which a limited partnership interest (with no right to liquidate) was discounted 45% from the pro rata share of the enterprise value.]

MARKETABILITY DISCOUNTS

A second, but related, discount is called for when there is a lack of an active market for business interests. Rev. Rul. 59-60 expressly recognizes the applicability of marketability discounts to closely held stock by acknowledging "that a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock." The courts have consistently found in favor of discounting closely held interests for relative lack of marketability. [See, for example, *Estate of Clara Winkler*, 57 T.C.M. 373 (1989).]

As with minority interests, the magnitude of marketability discounts is determined by the facts and circumstances in each case. Studies of actual market activity can provide a foundation for establishing an appropriate discount.

KEY PERSON DISCOUNTS

Some business entities are highly dependent upon a "key individual." Future cash flows would likely decline in the event the key individual is unable or unwilling to perform in his customary role. The *Land* court explained the rationale for applying the discount in an estate tax setting:

> To find the fair market value of a property interest at the decedent's death, we put ourselves in the position of a potential purchaser of the interest at that time.... a potential buyer focuses on the value the property has in the present or will have in the future. He attributes full value to any right that vests or matures at death, and he reduces his valuation to account for any risk or deprivation that death brings into effect, such as the effect of the death on the brain's of a small, close corporation. [*United States v. Land*, 303 F.2d 170, 173 (5th Cir., 1962)].

UNDIVIDED INTEREST DISCOUNTS

In certain cases, discounts on undivided interest in real estate have been allowed. For example, in *LaFrak v. Commissioner*, 66 T.C.M. 1297 (1993), the court found that "a minority discount for an interest in real property may be allowed on account of the lack of control which accompanies co-ownership... however, a fractional interest in real property has the power to compel partition of the property, which is not available with other shared ownership interests." A minority discount of 20% was allowed, increased to 30% to reflect the relative lack of marketability. In *Estate of Alto v. Cervin*, T.C.M. 1994-550, a 20% discount was applicable to an undivided one-half interest in a farm because partition would create legal fees, appraisal fees, and delay. The court noted that under Texas law the purchaser of a fractional interest in property incurs all costs associated with a forced sale.

The most important considerations in determining the magnitude of a minority discount are lack of ability to control or influence the management of the business, lack of ability to cause a sale of the entity or its assets, and lack of ability to cause distributions.

The most important considerations in determining the magnitude of a marketability discount are the lack of a ready market, the inability to make a market, and absence of current benefits of ownership (e.g., distributions, impending public offering of sale of assets). Combined, these factors mean the owner of the interest has an indeterminable holding period.

Generally, minority and marketability discounts are not enhanced significantly by the use of multi-tiered entities.

Note

- This discussion of valuation strategy relies heavily on a superb discussion of *Tax Effective Valuation Strategies* dated March 1, 1996, by J. Peter Lindquist of Quist Financial, Inc., of Boulder, Colorado, and a short related piece by Mr. Lindquist on *Minority and Market Discounts in Multi-Tiered Entities.*

  - Tax Discount

    Recently, courts have acknowledged the economic reality that in valuing family gifts and transfers of corporate stock, an allowance should be made for the potential capital gains taxation inherent in C Corporation stock. In *Eisenberg v. Commissioner*, 82 A.F.T.R. 2d (2d Cir., 1998), the court rejected the IRS contention that no discount should be permitted for a contingent tax liability because that tax liability is too speculative. The Appeals Court concluded:

    > Now that the T.R.A. (1986) has effectively closed the option to avoid capital gains taxation at the corporate level, reliance on these (past) cases in the post-T.R.A. environment should, in our view, no longer continue. Our concern is not whether or when the donees will sell, distribute, or liquidate the property at issue, but whether and what a hypothetical buyer would take into account in computing fair market value of the stock. We believe it is common business practice and not mere speculation to conclude a hypothetical willing buyer, having reasonable knowledge of the relevant facts, would take some account of the tax consequences of contingent built-in capital gains on the sole asset of the corporation at issue in making a sound valuation of the property.

In *Estate of Davis v. Commissioner*, 110 T.C. 35 (1998), the Tax Court reached a similar position. The court found that the logic forced the court "to reject respondent's (IRS) position that, as a matter of law, no discount or adjustment attributable to built-in capital gains tax is allowable….a hypothetical willing seller and a hypothetical willing buyer would not have agreed on that date on a price for each of the blocks of stock in question that took no account of the corporation's built-in capital gains tax."

Commentators have addressed the issue as follows (See *Tax Practice and Accounting News)*. "Stock Valuations, as a Matter of Law, Require Tax Discount" by William L. Raby and Burgess J.W. Raby:

> Where the underlying assets are depreciable or amortizable, we think that the minimum discount that should be applicable would be that which would be produced by assuming that current tax and interest rates continue indefinitely and then calculating the present value of tax attributable to the lower depreciation or amortization that the assets will have as compared to that which would be produced if they were written up to their current value.
>
> For example, assume that the tax basis of a corporation's amortizable asset is $150,000 and the remaining amortization period is 10 years. Thus, the corporation is able to tax a deduction of $15,000 per year for amortization. A hypothetical purchaser of corporate stock would pay for that stock based upon valuing the amortizable asset at $1,500,000. If the asset itself is purchased, the amortization period would be 15 years. Thus, in a purchase without tax detriment, the asset would produce $100,000 a year of amortization. The applicable corporate tax rate, federal plus state, is 40%.
>
> In valuing the built-in tax, we are suggesting that the present value of the $15,000 per year at the 40% rate or $6,000 per year for 10 years could be compared to the present value of $100,000 per year at the 40% rate, or $40,000 for 15 years. Using a discount rate of 15%, this would produce $203,782 ($30,113 vs. $233,895) as the value of 100% of the built-in tax as a hypothetical purchaser might perceive it. If a 10% interest in the corporation is being valued, the applicable discount would then be $20,378.

The IRS may argue that the rationale of the *Eisenberg* and *Davis* cases does not apply to an S corporation. The cases imply that the S corporation is not affected by the demise of the General Utilities Rule. In *Davis*, the judge pointed out that "a subchapter C corporation can avoid recognition of gain if the corporation converts to a subchapter S corporation and retains the assets for a period of 10 years." Insightful commentators (and specifically, Raby) observe:

> Just as with C corporations, distributions of assets even from S corporations result in triggering income to the extent the fair market value of the asset distributed exceeds its tax basis to the corporation.

Any disposition of the assets by the continuing S corporation will trigger recognition of the built-in gain. While it will not be taxed to the corporation, it will be taxed to the shareholders. Moreover, corporations, partnerships (including LLCs) and even non-resident aliens may be potential buyers of many businesses, especially larger ones. Not one of these is a qualified S corporation shareholder.

GIFT TAX

UNIFIED SYSTEM

The federal gift tax system has been integrated with the federal estate tax system. Prior to 1981, they were separate systems rather than a unified transfer tax system. The gift tax is effectively imposed at the same rates as the estate tax [IRC §2502(a)].

DEFINITION OF GIFT

Gratuitous transfers are taxable. Donative intent is not necessary as long as the transfer is complete and the donor has parted with dominion and control (IRC §2511).

ANNUAL EXCLUSION AND QUALIFIED TRANSFER EXCLUSIONS

The first $10,000 of present interest gifts to each donee in each calendar year is excluded in computing the total amount of gifts made during that year for gift tax purposes. The $10,000 amount is increased by a cost of living adjustment and rounded to a multiple of $1,000 under the provisions of the Taxpayer Relief Act of 1997.

It is essential, then, that any gift intended as a $10,000 annual exclusion gift be in a form which constitutes a "present interest" for purposes of IRC §2503 of the federal gift tax.

UNIFIED CREDIT

The unified credit was described previously in the estate tax discussion. The same unified credit, which is applied against the estate tax, is integrated with the gift tax provisions. The unified credit corresponds to an exemption amount of $650,000 in 1999 which increases each year until it reaches $1,000,000 in the year 2006. The unified credit may be used for transfers by gift during lifetime, or for transfers from the estate after death.

Marital Deduction

There is an unlimited marital deduction for gift tax purposes. If the donor transfers by gift an interest in property to a donee, who at the time of the gift is the donor's spouse, there is allowed as a deduction in computing taxable gifts an amount with respect to such interest equal to its value [IRC §2523(a)]. As with the estate tax, the marital deduction is limited for gifts to a spouse who is not a U.S. citizen.

Charitable Deduction

For gift tax purposes there is an unlimited charitable deduction. There is allowed as a deduction in the case of a citizen or resident the amount of all gifts made to or for the use of the United States, any state, any political subdivision, or any qualified charity organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition, including the encouragement for and the prevention of cruelty to children or animals [§ 2522(a)].

There is also a deduction for income tax purposes for charitable gifts, but that deduction is not unlimited.

Tuition — Medical Care

Section 2503 permits not only an annual exclusion for $10,000 but also an exclusion for certain qualified transfers for education expenses or medical expenses. In addition to the $10,000 exclusion, there may be excluded from what would otherwise be a taxable gift:

- Any amount paid on behalf of an individual as tuition to an educational organization for the education or training of such individual.
  - The amount must be paid directly to the educational organization.
- Any amount paid on behalf of an individual to any person who provides medical care with respect to such individual as payment for such medical care.
  - The payment must be made directly to the medical provider.

Statutory Limitations

It is mainstream planning, then, to establish a trust as a part of a family gift program. If a donor establishes a trust for a child or grandchild and makes gifts to that trust, there are several statutory limitations which must be kept in mind.

VALUATION DISCOUNTS

The valuation discounts, noted above, can play a major role for a closely held business in increasing the effectiveness of a gift program.

Chapter 2

Traditional Testamentary Planning

INTRODUCTION

Each couple with a substantial net worth must address the impact of the federal estate tax in the planning process. This is true whether or not their estate includes a closely held business. It will be useful to review the key planning structure for couples with a net worth significantly in excess of the applicable credit amount and then focus on special planning issues which apply for a couple with a closely held business.

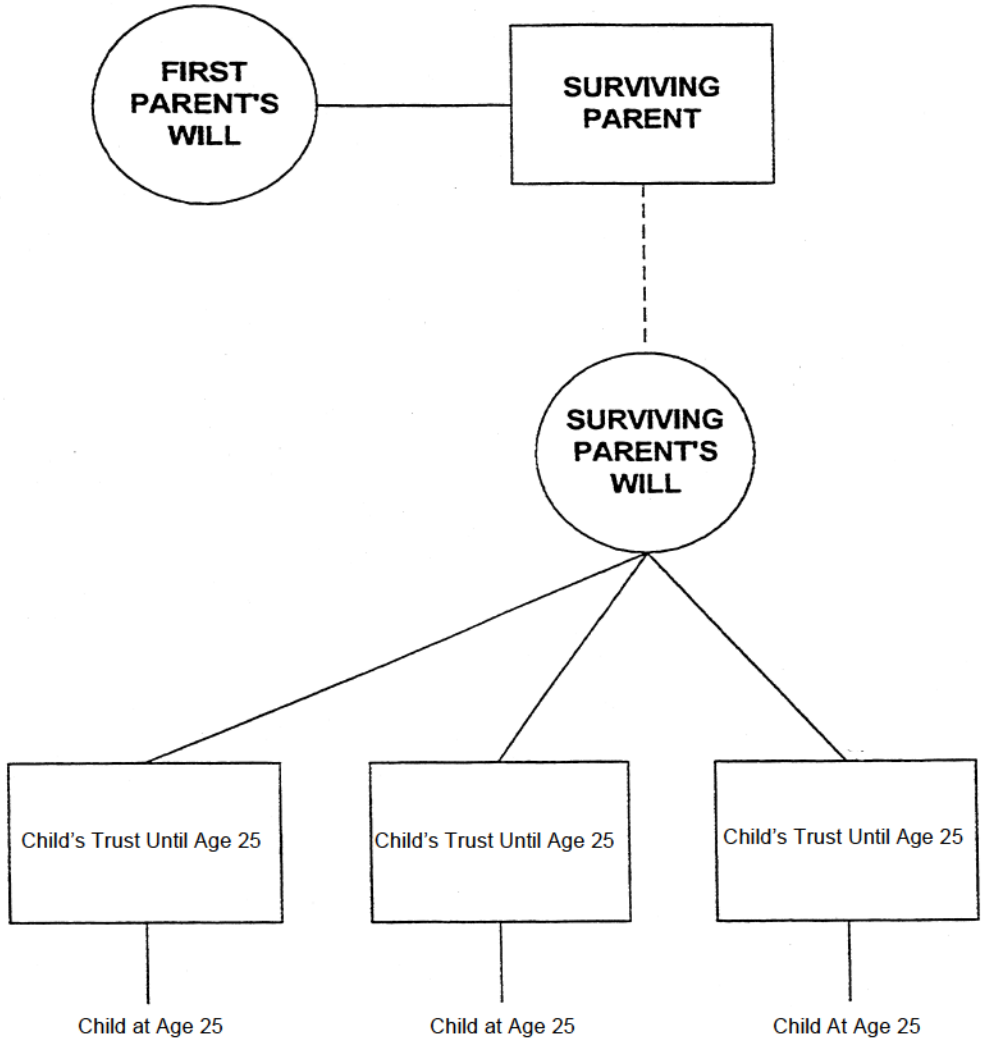
PLANNING WITH SIMPLE WILL

EXAMPLE 2–1:

- Consider a couple with two children and assets totaling $250,000.
- For a family with a moderate net worth, traditional planning would suggest a simple will for the husband and a simple will for the wife.
- The husband's will might provide, for example:

(continued)

> *I leave my entire estate outright to my wife. If my wife does not survive me, I leave my entire estate in equal shares to my two children, with the share of any deceased child passing to such deceased child's children. If a child of mine has not attained 25 years of age, such child's share shall be held in trust for such child's health, support, maintenance, and education under Article IV. My oldest living sibling shall be trustee of any such trust.*



DISCUSSION:

- From a federal estate tax point of view, if the wife survives, the property will pass to her shielded from estate tax by the unlimited marital deduction.
- If the wife does not survive, the property will pass to the children (possibly in trust) shielded by the applicable credit amount.
- If, in fact, the total estate is $650,000, the entire estate will be shielded from federal estate tax.
- If the estate is larger, this simple will approach may result in a significant estate tax.

EXAMPLE 2–2: Plumbing Perfection

- Note that a relatively simple will may represent appropriate planning for Don and Patricia, owners of Plumbing Perfection.
- The business which generates approximately $650,000 of annual gross revenue may have a net worth of $300,000.
  - Their other main asset is their residence, with a value of $175,000.
  - If these are the principal assets, their net worth is well within the applicable credit amount.
- If Don were to die with an estate of $550,000 and a simple will, the entire estate would pass to Patricia free of federal estate tax under the unlimited marital deduction.
- If Patricia were to die later with an estate in that range, there would be no federal estate tax upon the transfer to the children.

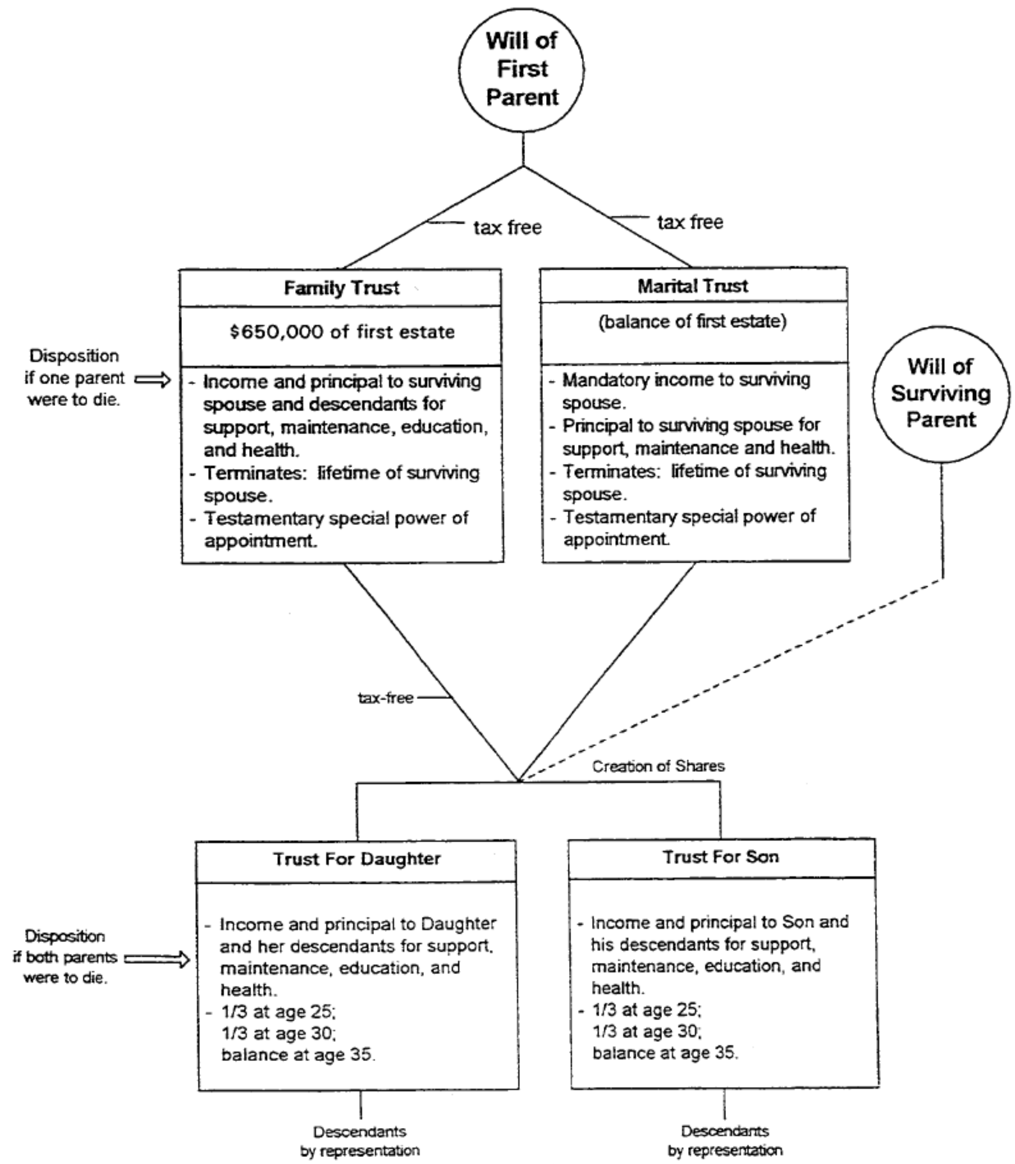
EXAMPLE 2–3:

- Clearly, however, a simple will does not represent adequate planning for a couple like Mike and Mildred, owners of Marvelous Masonry.
- They have a combined estate of approximately $3,500,000.
- Assume that Mike died in 2003 with a simple will.
  - There would be no federal estate tax.
  - Mildred, however, would then have an estate of $3,500,000.
- If Mildred were to die after 2005, she could apply her exemption equivalent amount of $1,000,000, leaving $2,500,000 subject to federal estate tax.
- Such planning with simple wills would result in federal estate tax of approximately $1,250,000.

TRADITIONAL TAX PLANNING FOR MARRIED COUPLES WITH SUBSTANTIAL ESTATE

STANDARD APPROACH

For couples with larger estates (significantly over the applicable unified credit amount) such as Mike and Mildred, the traditional recommendation is for husband and wife each to have a will which sets aside from the first estate the applicable credit amount. The applicable credit amount is usually distributed to a Credit Shelter Trust for the benefit of the surviving spouse and children.



CREDIT SHELTER TRUST

Tax Purpose

In traditional planning, the first parent's will would set aside the applicable credit amount into a Credit Shelter Trust, with the balance of the estate passing to the surviving spouse. The key factor from a federal estate tax planning perspective is that assets in the Credit Shelter Trust are not subject to federal estate tax in the surviving spouse's estate. As explained below, the surviving spouse may have substantially full control and full benefit of the assets in the Credit Shelter Trust. The surviving spouse, in effect, may "have the cake and eat it too." The funds in the Credit Shelter Trust are fully available to the surviving spouse and family but eventually pass free of federal estate tax to the second generation.

Different Terms

The trust is referred to by several different terms:

- **Credit Shelter Trust** (because the trust is generally funded with an amount of property equal to the unified credit and eventually is sheltered from federal estate tax upon transfer to the second generation).
- **Bypass Trust** (because the remaining trust estate bypasses the taxable estate of the surviving spouse).
- **Family Trust**.
- **Disclaimer Trust** (because some planners structure the estate plan to fund the trust by way of a disclaimer by the surviving spouse).

This planning is often called marital deduction planning because the applicable credit amount is protected by transfer to a Credit Shelter Trust and the balance of the estate is shielded from federal estate tax by the unlimited marital deduction.

Distributions of Income and Principal

If the surviving spouse is trustee of the Credit Shelter Trust, it is important that the distributions of principal be limited to health, support, maintenance, and education (so the surviving spouse will not be deemed to have a general power of appointment which would cause the assets remaining in the Credit Shelter Trust at the death of the surviving spouse to be included in the surviving spouse's taxable estate).

With this important exception, there are no other material limitations on the provisions which govern distributions of income and principal. The Credit Shelter Trust may provide, for example, for mandatory distributions of income to the surviving spouse and discretionary distributions of principal. Alternatively, and more commonly, the Credit Shelter Trust may provide:

> *The trustee shall distribute income and principal to my surviving spouse and to my descendants as the trustee may determine to be necessary or advisable to provide for the health, support, maintenance, and education of such respective beneficiaries.*

Testamentary Power of Appointment

Typically, the Credit Shelter Trust will continue for the life of the surviving spouse which may be an additional 20 to 30 years. Older grandchildren may be born during that time and the personal and financial circumstances of the family may change greatly. Therefore, the surviving spouse is commonly granted a testamentary "special power of appointment" over the assets of the Credit Shelter Trust. This legal authority gives the surviving spouse the power, by her will, to allocate the trust estate remaining at death.

General Power of Appointment

If the surviving spouse has a **general** power of appointment, then the assets in the Credit Shelter Trust will be included and taxable in the estate of the surviving spouse. This clearly should be avoided. The surviving spouse has a general power of appointment if the surviving spouse (as trustee) has the authority to appoint the property to the surviving spouse, the surviving spouse's creditors, the surviving spouse's estate or the creditors of the surviving spouse's estate (§2041).

Limited or Special Power of Appointment

The surviving spouse may be granted a limited or special power of appointment, one which prohibits appointment of the property to the surviving spouse, the surviving spouse's creditors, the surviving spouse's estate, or the creditors of the surviving spouse's estate. This is an approach which gives the surviving spouse the flexibility by her will to allocate the remaining trust estate without causing the assets to be taxed in the survivor's estate. Subject to this limitation, there are three common approaches:

1. The majority of clients provide that the special power of appointment over the assets in the Credit Shelter Trust may be exercisable only in favor of the couple's descendants (children and grandchildren). The use (by the survivor) of such a special power of appointment may be illustrated by the following exercise under the will of the surviving spouse:

   > *I was granted a special power of appointment over the assets in the Credit Shelter Trust established by my husband at the time of his death. I have three children. I love my oldest child dearly but recognize that he has been very successful financially and has accumulated great personal wealth. Therefore, I exercise the special power of appointment to appoint the assets in the Credit Shelter Trust in equal shares to my two younger children, each of whom is a schoolteacher.*

2. Some clients take the opposite extreme not limiting the exercise of the special power of appointment to descendants but rather permitting appointment of the remaining trust estate to any person or persons (subject to the limitation of §2041). The surviving spouse may appoint the property to the new spouse, the next door neighbor, or an extremist group.

3. Other clients take a middle approach. The Credit Shelter Trust may provide:

> *Upon the death of my spouse, my spouse shall have a special power of appointment exercisable by the will over the assets in the Credit Shelter Trust. The power of appointment shall be exercisable among my descendants, provided, however, that my spouse may appoint up to 33% of the assets to any person(s) chosen (other than my spouse, my spouse's creditors, my spouse's estate, and the creditors of my spouse's estate).*

CREDIT SHELTER TRUST TRUSTEE

There are no substantial limitations on who may be the trustee of the Credit Shelter Trust. It may be the surviving spouse, a bank, an independent party, or an arrangement of co-trustees. If the surviving spouse is a spouse of a second or subsequent marriage, it is common to name co-trustees of the Credit Shelter Trust. If the surviving spouse is the spouse of the first marriage, then generally the surviving spouse is named as **sole** trustee of the Credit Shelter Trust.

As earlier noted, tax attributes are important in this regard:

- If the surviving spouse is sole trustee of the Credit Shelter Trust, then distributions of principal must be limited to health, support, maintenance, and education. To reiterate, this is the so-called **"ascertainable standard"** (§2041).
- If the surviving spouse is sole trustee of the Credit Shelter Trust and the Trust permits distributions of principal to the surviving spouse for "happiness" or "comfort" or "general welfare," then the surviving spouse is deemed to have a **general power of appointment** over the Credit Shelter Trust assets and the assets will be included in the estate of the surviving spouse. This limitation that principal distributions be limited to health, support, maintenance, and education if the surviving spouse is trustee of the Credit Shelter Trust is of critical importance.
- From an income tax perspective, if the spouse has the legal authority as trustee to distribute the income herself, then the income will be taxable to the surviving spouse even though the income may be distributed to a different person. Assume the provision in the Credit Shelter Trust governing the distribution of income is as follows:

> *The trustee may distribute the income to any one or more of the group consisting of my spouse and my descendants as the trustee may determine to be reasonable and appropriate.*

With this provision, even if the surviving spouse distributes the income to the children, the income will be taxable to the surviving spouse. (See generally §678.)

ADDITIONAL INCOME TAX CONSIDERATION

If there is an independent trustee and if the Credit Shelter Trust makes no distribution of income, the income may be subject to tax as trust income on Form 1041. A trust reaches the highest federal income tax bracket at $8,100 of trust income. If the surviving spouse is in a lower income tax bracket, it may be advantageous to distribute the income to the surviving spouse (to shift the taxability of the income to the spouse's Form 1040 and to the lower bracket).

However, if the income tax bracket of the surviving spouse is the same as or higher than the Credit Shelter Trust, then it may be advantageous to accumulate the income in the Credit Shelter Trust. If there is no significant **income tax disadvantage** to accumulating the income in the Credit Shelter Trust, then there is an **estate tax advantage** to such accumulation.

If the income is distributed to the surviving spouse, then that net income (and future appreciation on that net income) will be subject to federal estate tax in the estate of the surviving spouse. If the net income is accumulated in the Credit Shelter Trust, the net income (and the future appreciation on that net income) will **escape federal estate taxation** in the estate of the surviving spouse.

CREDIT SHELTER TRUST — TRUSTEE WITH CLOSELY HELD BUSINESS

For couples who own a closely held business, the management of the assets in the Credit Shelter Trust (or Marital Trust) may be an issue requiring particular attention. There are a number of considerations:

Corporate Trustee

It is uncommon for a corporate trustee to be willing to assume the trusteeship if a main asset of the trust is a closely held business. A corporate trustee or a bank trust department may be willing to assume this responsibility for a transitional period but an institutional trustee will typically not manage a closely held business for a long term. Moreover, there are often significant additional fees imposed by a corporate trust department with respect to the management of a closely held business. A bank trust department will generally be experienced and expert in managing a portfolio of publicly traded stocks and bonds but a bank trust department will generally not manage a masonry business or a sod farm enterprise.

Family Member

Sometimes there will be a family member with the experience to run the business.

EXAMPLE 2–4:

- For Marvelous Masonry, son Tim, age 34, is already beginning to assume control of the business.

(continued)

EXAMPLE 2–4 (continued)**:**

- If Mike were to die, shares in the Marvelous Masonry Inc. may pass to the Credit Shelter Trust.
- Mike's will may appoint Mildred and Tim as co-trustees of the Credit Shelter Trust and Marital Trust—to provide the necessary expertise for the continued management of the business.

Named Consultant

The person with business expertise need not be named as a trustee in order that such expertise is available to the family for the continued management of the closely held business.

EXAMPLE 2–5:

- For Marvelous Masonry, Mike may decide not to name Mildred and Tim as co-trustees.
- Rather Mike may name Mildred as sole trustee of the Credit Shelter Trust and the Marital Trust, with the expectation that Tim will provide his expertise and management skill in the operation of the business even though he is not named as a trustee.

EXAMPLE 2–6:

- Similarly, if Don, owner of Plumbing Perfection, were to die, Patricia may rely on key employee Jack with respect to the continuation of the business, even though Jack may not be named in any official fiduciary capacity under Don's will.
- Obviously Jack's familiarity with the Plumbing Perfection business would be critical if both Don and Patricia were to die.
- Often a will contains a provision which does not officially appoint a key management person as personal representative or trustee but recommends a consultation.
- Don's will may provide, for example:

> *If I die, the operation or sale of Plumbing Perfection will likely be a key financial aspect of the administration of my estate. I trust the business judgment and integrity of my key employee, Jack. I encourage the family members who are administering the estate to rely on Jack's experience, knowledge of our customer base, and management skill.*

Business Continuity Plan

In addition, the owner of a closely held business may prepare a written *Business Continuity Plan* to serve as a practical guide to family members.

Many couples who own a closely held business find it useful to periodically prepare a written Business Continuity Plan to provide information to the family about the continued operation of the business.

EXAMPLE 2–7:

- Consider Jim and Jane, owners of Spectacular Sod.
- They may have a weekend planning retreat once a year with their two sons to update the family Business Continuity Plan.
    - This writing will serve as a guideline to help shape practical aspects of business continuity.
- For Spectacular Sod, Jim, Jane, Will, and Derrick should ask the following questions:
    - If Jim were to die, who would replace his "supervisory and entrepreneurial skills?"
        - Would Will assume additional management responsibilities? What management responsibilities?
        - Would Derrick assume additional management responsibilities? What management responsibilities?
        - Would an existing employee be promoted to additional management tasks and responsibilities?
        - Would it be necessary/advisable to hire a new employee or employees to compose an effective management structure if Jim were to die?
        - Should there be the hiring of new employees or the expanded training of employees (including Will and Derrick) to provide for the eventuality of Jim's retirement and/or death?
    - What financial steps would be required if Jim were to die (or if Jim and Jane were to die)?
        - What is the amount of company debt?
        - Would there be an additional bonding requirement. (Note that this bonding requirement may arise for a business, such as a construction business, upon the death of both parents.)

(continued)

EXAMPLE 2–7 (continued)**:**

- For a large estate, there would be the payment of federal estate tax.
- For a business like Marvelous Masonry, a substantial part of the family wealth may pass to family members who will not continue to be a part of the business (and hence who will not pledge their assets as part of a bonding requirement.)

- Should a particular division or asset be identified for sale—to provide liquid funds if the business owner dies?
  - In Spectacular Sod, for example, the Business Continuity Plan might identify one or more of the tracts of real property poised for development for sale in the event of Jim's death.
- If a sale of the business is possible, the Business Continuity Plan may identify steps to prepare the business for sale, potential buyers, and potential pluses and minuses in the marketing process.

The family's accountant may play a useful role in proposing an annual meeting and preparation of a Business Continuity Plan. Focusing on practical business continuity does not have to take place at a particular time of the year, it may be scheduled during the summer or fall (and, in any case, not during the "tax season"). While some families may do this business planning on an annual basis at a weekend retreat, it may be that a two-to-four-hour meeting would provide adequate time.

- For families with closely held businesses which do prepare a written Business Continuity Plan, the discussion of these issues inevitably addresses key current planning issues.
- The experience of most families who own a closely held business is that the annual update of a written Business Continuity Plan also serves as a strategic planning session on operational and structural issues currently facing the business.

MARITAL GIFT

TAX DESIGN

Generally the recommended structure is to allocate the applicable credit amount ($650,000 in 1999) to the Credit Shelter Trust and the balance to the surviving spouse. The funds passing to the surviving spouse are shielded from federal estate tax by the unlimited marital deduction. No tax is due.

EXAMPLE 2–8:

- Consider a husband with $1,900,000 of assets.
- The husband may have a will which provides for the set-aside into the Credit Shelter Trust of the applicable credit amount and the balance to the surviving spouse.
- In 1999, this would result in a distribution of $650,000 to the Credit Shelter Trust and the balance of $1,250,000 to the surviving wife.

NON–PROBATE ASSETS

Often, a significant share of the husband's property is "non-probate assets." That is, many assets pass independent of the will.

EXAMPLE 2–9:

- Husband has $1,900,000 of assets:

IRA payable to wife	$400,000
Residence - joint tenancy	$250,000
Investment account - joint tenancy	$300,000
Investment account - personal	$800,000
Insurance payable to wife	$150,000

- In this example, $1,100,000 of assets will pass directly to the surviving wife as named beneficiary and as surviving joint tenant.
- The amount of $800,000 will be governed by the will.
  - Of this amount, $650,000 (1999) will be allocated to the Credit Shelter Trust and the balance of $150,000 to the marital share.

MARITAL TRUST

To the extent the funds are governed by the will and are allocated to the marital share, the funds may be distributed to the surviving spouse **outright** or **in trust**. There are three types of marital trusts:

1. **QTIP Trust**

   This is a trust which holds Qualifying Terminable Interest Property (that is, a property interest which terminates on the death of the surviving spouse but nevertheless qualifies for the marital deduction). This type of trust, called a QTIP trust, was introduced into the law in 1981. It is by far the most common type of marital trust to hold the marital share. It must meet these three essential requirements:

- The QTIP Trust must provide the mandatory distribution of income to the surviving spouse for her whole lifetime (even if the surviving spouse remarries).
- The surviving spouse must be the only beneficiary of income and principal.
- Upon the eventual death of the surviving spouse, the remaining assets in the QTIP Trust will pass to the beneficiaries named by the first decedent (and not by the surviving spouse, unless the will grants the surviving spouse a testamentary special power of appointment, as noted below).

2. General Power of Appointment Trust

Prior to 1981, funds transferred to a Marital Trust for the surviving spouse qualified for the marital deduction only if the surviving spouse had a "general power of appointment" over the assets of the Marital Trust. That is, a marital deduction was permitted (so that no federal estate tax was due on the transfer of property from the decedent to the surviving spouse) only if the surviving spouse had the ability to "appoint" the Marital Trust to any person(s). The surviving spouse, for example, could appoint the remaining assets in the Marital Trust to the surviving spouse's new spouse.

Prior to 1981, the marital deduction was **not** an **unlimited marital deduction**. Rather, the marital deduction was equal to $250,000 or one-half of the estate, whichever was greater. Therefore, classic marital deduction planning prior to 1981 had three attributes:

- Distribution of one-half of the estate to the Marital Trust.
- Marital Trust provided for mandatory distribution of income to the surviving spouse.
- Marital Trust granted the surviving spouse a general power of appointment.

3. Estate Trust

Rarely used, a transfer of assets to an Estate Trust qualifies for the marital deduction. This trust does not require that mandatory income be distributed to the surviving spouse but requires that the remaining income and principal upon termination (that is, upon the death of the surviving spouse) be distributed to the estate of the surviving spouse.

CLOSELY HELD BUSINESS — SPECIAL FUNDING CONSIDERATIONS

CREDIT SHELTER TRUST

Under the traditional planning, the first decedent's estate plan will set aside an amount equal to the applicable credit to the Credit Shelter Trust.

EXAMPLE 2–10:

- If a husband dies in 2003 (with wife surviving), the husband's will would set aside to the Credit Shelter Trust an amount of $700,000.
- Upon the surviving wife's later death, the assets in the Credit Shelter Trust typically pass to the children with two notable tax attributes:
  - The assets in the Credit Shelter Trust pass to the children free of federal estate tax.
  - The assets in the Credit Shelter Trust do **not** receive a step-up in basis for income tax purposes.

USE OF DISCOUNT

Because the assets in the Credit Shelter Trust will pass free of federal estate tax to the children upon the death of the surviving parent, it is generally advisable to transfer maximum value to the Credit Shelter Trust. This is one circumstance in which the family may take advantage of the discount associated with an interest which does not constitute 100% ownership of a closely held business.

EXAMPLE 2–11:

- Marvelous Masonry has a value of approximately $2,500,000.
- Assume for purposes of illustration that the ownership of Marvelous Masonry is as follows:

Mike	48%
Mildred	48%
Tim (son)	4%

- If Mike were to die, his 48% interest would have a nominal value of $1,200,000 (namely 48% of $2,500,000).
  - It would be typical, however, to discount the value of Mike's minority interest by a substantial percentage, perhaps as great a discount as 33%.
  - Then Mike's 48% interest has a value of $800,000 for federal estate tax purposes, not $1,200,000.
- Assume Mike died in 2003 when the applicable credit amount is $700,000.

(continued)

EXAMPLE 2–11 (continued)**:**

- There might be the transfer to the Credit Shelter Trust of a 42% ownership interest in Marvelous Masonry from Mike's estate to the Credit Shelter Trust.
  - Nominally, this 42% interest has a value of $1,050,000.
- Discounted by 33%, however, the 42% interest has a value for federal estate tax purposes of $700,000.
- By taking advantage of the discount permitted under the federal estate tax law for a non-marketable, non-controlling minority interest in a closely held business, it would be possible to transfer a substantially larger value to the Credit Shelter Trust.

Transfer of Appreciating Asset

For many families, the stock or equity interest in the closely held business may be an appreciating asset. Those families should contemplate the eventual transfer of a stock or equity interest in the closely held business to the Credit Shelter Trust (within the limits of the applicable credit amount). This is good planning because upon the eventual death of the surviving spouse, the assets in the Credit Shelter Trust will pass free of federal estate tax to the children — whatever the value of those assets is at that later date.

Obviously there will be circumstances in which the reverse will be true. If there is the loss of the key man (Jim in the Spectacular Sod business), then the value of the closely held business may be expected to depreciate subsequent to the death of the parent. In that circumstance, it may be more advisable to transfer other assets to the Credit Shelter Trust. It has been noted that for Jim and Jane, their assets consist not only of stock in Spectacular Sod but also of a number of tracts of real property including one now poised for development. One or more of those tracts of real property would be better suited for transfer from Jim's estate to the Credit Shelter Trust (because those tracts of real property may have more appreciation potential than stock in Spectacular Sod).

Basis Considerations

As noted, the assets in the Credit Shelter Trust are not subject to federal estate tax in the estate of the surviving spouse, but the assets do not receive a step-up in basis. The ideal, then, would be to transfer assets to the Credit Shelter Trust which have the following characteristics:

- Assets which are likely to appreciate significantly in value.
- Assets which may be discounted for federal estate tax purposes (to make possible a transfer of maximum value from the first parent's estate to the Credit Shelter Trust).
- Assets which are expected to remain in the family (and not be sold for the foreseeable future).

EXAMPLE 2–12:

- Returning to the situation of Jim and Jane, assume that among the tracts of real estate owned by the family, Jim owns two tracts of real property which are expected to appreciate significantly, Tract A and Tract B, each with a current value of approximately $500,000.
- Assume that the family expects to sell Tract A within a five-year period, but hold onto Tract B, another 10 to 20 years.
- If Jim were to die, it may be more advisable to transfer Tract B to the Credit Shelter Trust.
- Upon Jane's later death, Tract B will not receive a step-up in basis to its then fair market value but that may not represent an income tax disadvantage to the family, since they plan to hold Tract B for investment purposes for the long term.
- By contrast, if Jim's estate transferred Tract A to the Credit Shelter Trust, it would not receive a step-up in basis in Jane's estate.
- If Jane died four or five years later and the family decided to sell Tract A, there would be capital gain tax due on the appreciation between the date of Jim's death and the date of Jane's death (because there would be no step-up in basis for Tract A in Jane's estate).

Discussion:

- It is evident, then, that for families who own a closely held business (and other assets), the funding of the Credit Shelter Trust will be shaped by considerations of:
  - Value discount,
  - Potential appreciation of assets, and
  - Issues related to the step-up in basis and the plan for the eventual disposition of the property.

EXAMPLE 2–13:

- These basis considerations may play a role in the planning for Marvelous Masonry.
- Recall that son Tim is expected to take over the business and the family estate plan is eventually to pass non-business assets to daughters Ann and Barbara.
- Assume that Mike dies and the Credit Shelter Trust is funded with stock in Marvelous Masonry.

(continued)

EXAMPLE 2–13 (continued)**:**

- Upon Mildred's later death, that stock may pass in equal shares to the three children.
  - If it does, there may be a buy-sell arrangement in which Ann and Barbara are required to sell their shares in Marvelous Masonry to Tim, and Tim is obligated to purchase those shares.

Discussion:

- If that is the case, Ann and Barbara will face capital gains tax on the sale (on the appreciation in Marvelous Masonry subsequent to Mike's death) because there will be no step-up in basis in those shares.
- Therefore the possibility of intra-family sales must also be taken into account in the funding of the Credit Shelter Trust.

DEDUCTION UNDER §2057

As noted in Chapter 1, §2057 permits a deduction from the value of the gross estate of the adjusted value of qualified family-owned business interests (QFOB). This section applies to an estate that meets a number of conditions; a main requirement is that the sum of the adjusted value of the qualified family-owned business interests exceeds 50% of the adjusted gross estate. When the tax relief for QFOB was first introduced in the Taxpayer Relief Act of 1997, the tax protection was structured as an **exclusion** under §2033. In that context, the planning idea was to transfer to the Credit Shelter Trust not only the applicable credit amount ($625,000 in 1998) but also the $675,000 **excluded** from the estate under then §2033.

In the 1998 Tax Act, this tax protection for QFOB was changed, however, from an exclusion to a deduction. It is no longer possible to transfer the QFOB interest to the Credit Shelter Trust in addition to the applicable credit amount.

EXAMPLE 2–14:

- It is likely that the survivor of Mike and Mildred will be able to deduct an amount from the survivor's gross estate under §2057 (because the value of Marvelous Masonry will likely be substantially more than 50% of the gross estate of the survivor).
- For Jim, Jane, and Spectacular Sod, however, the value of Spectacular Sod, Inc. will likely be less than 50% of the value of the survivor's estate (given the substantial value of the investment real estate).
- Jim and Jane's estates, then, may not qualify for this QFOB deduction.

S Corporation Issues

A corporation may be disqualified as an S corporation if the shareholders do not maintain certain statutory requirements. Only certain types of trusts qualify to be shareholders of an S corporation. These include limited voting trusts, testamentary trusts and grantor trusts that are limited in duration, QSSTs, and ESBTs.

QSST

The Qualified S Shareholder Trust (QSST) may be a shareholder in an S Corporation. A QSST must have only one beneficiary during the life of the current income beneficiary who must be a citizen or resident of the United States. If the trust terminates during the life of the beneficiary, then all the assets must be distributed to the beneficiary. The beneficiary must elect QSST treatment for the trust.

EXAMPLE 2–15:

- Spectacular Sod is an S corporation.
- If Jim's will transferred stock in Spectacular Sod, Inc. to the Credit Shelter Trust, then the Credit Shelter Trust would qualify as a QSST only if the above requirements were met (and specifically only if there was one beneficiary).
- In the case of Jim and Jane, it may not be necessary to include the adult children (sons Will and Derrick) as beneficiaries of the Credit Shelter Trust.
- For many families, however, it is essential that the income and principal of the Credit Shelter Trust be available not only to the surviving spouse but also for the health, support, and education of younger children.
- In this circumstance, it may not be desirable to structure the Credit Shelter Trust as a QSST.

By contrast, it is generally easy to structure the Marital Trust as a QSST. The requirements for a QTIP Marital Trust (Qualified Terminable Interest Property Trust) are in many cases the same requirements for qualification as a QSST.

ESBT

The electing small business trust (ESBT) was recognized as an eligible S corporation shareholder under the Small Business Job Protection Act of 1996. The ESBT must meet three main requirements:

1. All trust beneficiaries must be individuals or estates who are eligible to be S corporation shareholders.
2. No interest in the ESBT may be acquired by purchase.
3. The ESBT must elect to be a small business trust.

The portion of an ESBT which consists of S corporation stock pays income tax at the highest rate for trust and estate income (otherwise imposed at $8,100), except for its capital gain. None of the items of income, loss, or deduction may be passed through to the ESBT beneficiaries and capital losses are allowed only to the extent of capital gains.

It may be possible, then, to establish a Credit Shelter Trust which has multiple beneficiaries (surviving spouse and children) and qualifies as an S corporation shareholder as an ESBT, but in that circumstance, there may be a significant income tax cost.

Basis Considerations

These potential planning limitations should be taken into account in establishing a new business entity. Indeed, there are two particularly important considerations which should influence the planner in deciding whether a new business entity should be a pass-through entity (partnership or limited liability company) or an S corporation.

1. Generally, a trust of any type can be an equity owner in a partnership or an LLC.
    - As noted, only a QSST or an ESBT can be a shareholder in an S corporation. The limitation to one beneficiary of the QSST and the high income tax rates of the ESBT can be significant disadvantages.
2. In an S corporation which holds highly appreciated assets, when a shareholder dies, that stock receives a step-up in basis but the assets owned by the S corporation do not receive a step-up in basis.
    - There is a step-up on the "outside"; there is no step-up in basis on the "inside."

If the assets of the S corporation are sold after the shareholder's death, it is possible to capture the economic benefit of the "outside" step-up in basis by selling the corporate assets and liquidating the S corporation, but generally only if the sale and liquidation take place in the same year.

COORDINATION OF BENEFICIARY DESIGNATIONS

The ownership of property and the beneficiary designations on life insurance and qualified retirement plans must be coordinated with the estate plan. It is not enough that the "design" of the estate plan is done well and the documents (wills, revocable trusts, etc.) are well-drafted. The ownership of property and the beneficiary designations must be coordinated with the estate plan.

LIFE INSURANCE

EXAMPLE 2–16:

- Husband had an estate which set aside the applicable credit amount into a Credit Shelter Trust and was made up of the following assets:

IRA payable to wife	$400,000
Residence - joint tenancy	$ 50,000
Investment account - joint tenancy	$ 40,000
Investment account - personal	$ 10,000
Insurance payable to wife	$750,000

- The wife was the first-named beneficiary on the life insurance.
  - If the husband died in 2003, only $10,000 would pass to the Credit Shelter Trust. The Credit Shelter Trust would be "underfunded."
  - There would not be full use of the husband's $700,000 applicable credit amount.
- It would be preferable for the husband to name the Estate of the Insured (or the revocable trust if the estate plan was embodied in a will and a revocable trust) as the first beneficiary.
- This beneficiary designation would channel the insurance proceeds into the estate, making the $750,000 of insurance proceeds available to help fill the Credit Shelter Trust.
- Notably, if husband and wife both died, this beneficiary designation would channel the insurance proceeds into the estate plan and into the trusts for the children to provide for the management of the property and possibly to accomplish generation-skipping goals.

QUALIFIED RETIREMENT PLAN

Generally the recommended beneficiary on a qualified retirement plan, 401k plan or IRA is the surviving spouse. This makes possible the rollover of the retirement plan into an IRA of the surviving spouse — avoiding, or at least deferring, any recognition of income.

TITLE TO PROPERTY

The ownership of property must be examined as part of the estate planning process. If the first decedent spouse has a will which provides for the set-aside of the applicable credit amount into a Credit Shelter Trust but has no property in her name, then almost certainly "underfunding" of the Credit Shelter Trust will occur. As noted, it is often advisable to do some balancing of the ownership of property.

EXAMPLE 2–17:

- Assume with respect to Marvelous Masonry, Mike owns 100% of the business (worth $2,500,000), Mike owns $800,000 of assets, and Mildred owns $200,000 of assets.
- If Mike were to die first, he has ample assets to fully utilize the applicable credit amount in funding the Credit Shelter Trust, making possible the reduction in federal estate tax upon the eventual transfer of family assets to the children.
- If Mildred were to die first, however, she has only $200,000 of assets.
- If Mildred were to die in 2003 with the applicable credit amount of $700,000, Mildred's estate plan would "underfund" the Credit Shelter Trust by $500,000.
- This suggests that upon Mike's later death, there would be the "unnecessary" payment of federal estate tax of approximately $250,000.

DISCUSSION:

- The ideal would be if Mike and Mildred each had $1,000,000 of property in his or her name—to take advantage of the full applicable credit amount by 2006 **and** to take advantage of the $1,000,000 generation-skipping tax exemption.
- Mike may consider, for example, transferring $800,000 to Mildred.
  - This would make it possible to take advantage of Mildred's applicable credit amount and $1,000,000 generation-skipping tax-exemption if Mildred were to die first.
- These issues of coordination may be particularly important for the accountant to consider.
  - The estate-planning attorney may see a client only once in a 10- or 15-year period and may not be aware of the acquisition of new property, new insurance policies, and the establishment of qualified retirement plans.

The **accountant** will serve the client well if the accountant sensitizes clients to the importance of these ownership and beneficiary designation issues and "nudges" clients to update wills and estate plans to accommodate all the changes that may have occurred in this regard.

For all couples, whether or not their net worth includes a closely held business, there must also be consideration to the title to property. To reiterate, the ideal would be if husband and wife each has $1,000,000 of property in his or her name. The planning based on the set-aside of the Credit Shelter Trust (and planning designed to take advantage of the $1,000,000 federal generation-skipping tax exemption) may not work if the couple owns all the property in joint tenancy.

EXAMPLE 2–18:

- Let us assume that Jim and Jane, with Spectacular Sod, owned all of the family assets (including the company stock and the tracts of real estate) in joint tenancy with right of survivorship.
- If Jim were to die, nothing passes under his will.
  - He has no "probate property" (no property which passes under his will).
- All of the property would pass to Jane as the surviving joint tenant.
  - There would be no property to take advantage of Jim's applicable credit amount and to fill the Credit Shelter Trust.

It is sometimes the case that the problem can be solved after the first parent's death by a post-mortem disclaimer.

EXAMPLE 2–19:

- With respect to the applicable credit amount, Jane would disclaim the assets as the surviving joint tenant.
- These disclaimed assets would then be a part of Jim's estate and would pass under his will and could be used to fund the Credit Shelter Trust.

It may not always be possible to solve these problems by post-mortem disclaimer.

EXAMPLE 2–20:

It would be strongly preferable in this case study if one of these two alternatives were in place:

- Jim and Jane each own $1,000,000 of assets in his/her name.
- Jim and Jane own $2,000,000 of assets as tenants in common (and not as joint tenants with right of survivorship).
- If one of these two alternatives is in place, then there will be sufficient assets to fully use the applicable credit amount (even in 2006) and the $1,000,000 federal generation-skipping tax exemption, whether Jim or Jane is the first parent to die.

BASIC TAX RULES — GENERATION-SKIPPING PLANNING

Section 2601 of Chapter 13 imposes a tax on every generation-skipping transfer. It is a tax which is separate from and additional to the federal estate tax. Potentially, a transfer from the first generation (grandparent) to the third generation (grandchild) is subject to two taxes—the federal estate tax and the federal generation-skipping transfer tax.

GENERATION–SKIPPING TRANSFER

The generation-skipping tax is potentially imposed on the following transfers:

Taxable Distribution

- Grandfather establishes a trust for his son.
- The trust provides for the distribution of income to the son and the distribution of principal to the son and the son's children for health, support, maintenance, and education.
- The trustee makes a distribution of principal to the son's daughter (the granddaughter) for piano lessons.
    - This transfer represents a "taxable distribution."
    - It is a distribution to a "skip person" (the granddaughter, who is more than one generation below the transferor-grandfather).
- The tax is paid by the transferee (the granddaughter).

Taxable Termination

In the example above, the son dies and the property passes to his two children (the grandchildren).

- This represents a taxable termination.
- The tax is paid by the trustee.

Direct Skip

- The grandfather makes a $50,000 outright cash gift to his granddaughter.
- The transfer is shielded from federal gift tax by application of part of his unified credit.
    - Nevertheless, the transfer may be subject to federal generation-skipping tax as a "direct skip" (the direct transfer from generation one to generation three).
- The tax is paid by the transferor-grandfather.
- A direct skip may be an outright transfer to a granddaughter or a transfer to a trust for the granddaughter (if there is no person in the second generation who is a beneficiary of the trust, that is, there is no "non-skip person" who is a beneficiary of the trust).

Skip Person

Under §2613, the term "skip person" means:

- A natural person assigned to a generation which is two or more generations below the generation assignment of the transferor, or
- A trust
  - If all of the interests in such trust are held by skip persons, or
  - If—
    - There is no person holding an interest in such trust, and
    - At no time after such transfer may a distribution (including distributions on termination) be made from such trust to a non-skip person.

Deceased Parent

For purposes of determining whether any transfer is a generation-skipping transfer, if an individual is deceased at the time of the transfer, the generation assignment of any descendant of such individual is to be adjusted accordingly.

EXAMPLE 2–21:

- If a transferor-grandfather has a deceased son who has three living children (the grandchildren), those grandchildren are not considered "skip persons" with respect to the grandfather-transferor.
- Any transfer by the transferor-grandfather to any of those grandchildren is not to be considered a generation-skipping transfer subject to federal generation-skipping transfer tax.

Tax Rate

The applicable rate with respect to any generation-skipping transfer is the product of:

- The maximum federal estate tax rate (55%), and
- The inclusion ratio with respect to the transfer.
  - (The inclusion ratio is the percentage of a trust or transfer which is not exempt for federal generation-skipping transfer tax purposes.)

$1,000,000 GST Exemption

Every individual is allowed a GST exemption of $1,000,000 which may be allocated by such individual (or her executor) to any property with respect to which such individual is the transferor. Under §2631(c), for an individual who dies in any calendar year after 1998, the $1,000,000 amount is increased by a cost of living adjustment (and is rounded to the lowest multiple of $10,000). For 1999, this amount has been increased to $1,010,000 (Rev. Proc. 98-61). However, for simplification, we will continue to refer to the GST exemption as $1,000,000 for the rest of this book.

EXAMPLE 2–22:

- Jim (of Spectacular Sod), through his will, transfers property with a value of $1,500,000 (net of federal estate tax) to a trust for his younger son, Derrick.
- The trust provides for the distribution of income and principal to Derrick for his health, support, maintenance, and education.
- Upon Derrick's death, the remaining trust estate will pass to Derrick's children (Jim's grandchildren) in equal portions.
- Upon the death of Jim, the executor allocates Jim's $1,000,000 GST exemption to the transfer.
  - Therefore, the trust has an inclusion ratio of two-thirds.
- Assume that upon the later death of Derrick, the property in the trust is worth $2,400,000.
- The amount of $1,600,000, or two-thirds of the trust estate, will be included and subject to federal estate tax in Derrick's estate.

Reporting

- The payment of any federal generation-skipping transfer tax and the allocation of the $1,000,000 GST exemption for inter vivos transfers is reported on a federal gift tax return (Form 709) Schedule R.
- The payment of any federal generation-skipping transfer tax and the allocation of the $1,000,000 GST exemption for testamentary transfers is reported on a federal estate tax return (Form 706) Schedule R.

Note:

- If the allocation of the GST exemption to any property is made on a timely filed gift tax return, then the value of the property for purposes of the allocation of the GST exemption is its value at the date of transfer.
- However, under §2642(b), if the allocation of the GST exemption is not made on a timely filed gift tax return, then the value of the transfer for federal generation-skipping transfer purposes is the value of the property at the time the allocation is **filed** (that is, at the time the late federal gift tax return is filed).
  - This provision can raise planning problems and opportunities.
    - If the value of the property increases between the date of gift and the date of filing of the late federal gift tax return, there is the use of an unnecessarily larger amount (than would be necessary if the federal gift tax return had been timely filed) of the $1,000,000 GST exemption.
    - However, if the property decreases in value (as in the instance where an insurance premium is paid to an irrevocable insurance trust but the cash surrender value of the policy at the time the late federal gift tax return is filed is less than the amount of the premium), a smaller amount of the GST exemption can be used.

TRADITIONAL PLANNING — WITH GENERATION–SKIPPING

CREDIT SHELTER TRUST — QTIP TRUST

This chapter earlier described a recommended estate plan for a couple with a net worth substantially in excess of the applicable credit amount. Typically, the husband's estate plan would provide for a set-aside of the applicable credit amount into a Credit Shelter Trust and the balance into a QTIP Trust.

For many couples, the estate plan provides that the eventual inheritance will pass outright to the children. In many circumstances, the children are of a reasonable age of maturity. It is not necessary to hold the inheritance in trust for a minor or irresponsible child.

PLANNING DILEMMA

EXAMPLE 2–23:

- Consider the estate plan of Mike, Mildred, and Marvelous Masonry.

(continued)

EXAMPLE 2–23 (continued)**:**

- If Mike and Mildred both die after 2005, $2,000,000 will be protected from federal estate tax by their combined unified credits.
- This will leave approximately $1,500,000 subject to tax, generating federal estate tax of approximately $740,000.
- This means that a net estate of $2,760,000 will pass to the three children (Tim, Ann, and Barbara).
  - Each child will inherit the net amount of approximately $920,000.
- You may recall in the Marvelous Masonry case study, son Tim is married to Laura who is from a wealthy family.
- If the $920,000 inheritance to Tim passes outright to him, that $920,000 inherited from Mike and Mildred may be subject to federal estate tax in Tim's later estate.
- At the rates of 50%, this would suggest that the inheritance would eventually generate another $480,000 of federal estate tax in Tim's estate if the property appreciates in value during Tim's lifetime, the $920,000 inheritance may have a substantially greater value when Tim dies.
- Indeed, if Tim survives for forty years and the $920,000 inheritance appreciates at 7.2%, the $920,000 inheritance (if not spent by Tim and his family) would increase to approximately $15,000,000.
- The possible and likely increase reflects a central theme of the financial world—the power of compound interest.

USE OF $1,000,000 GST EXEMPTION

As noted, each individual has a $1,000,000 GST exemption.

EXAMPLE 2–24:

- Mike and Mildred may structure their combined estate plan to capture and allocate their respective $1,000,000 generation-skipping tax exemptions.
  - This may be done so that the eventual $920,000 inheritance of each child is divided into a $667,000 "exempt" amount and a $253,000 "non-exempt" amount.
- In the typical situation, the $667,000 exempt amount would be paid to an exempt trust.

(continued)

EXAMPLE 2–24 (continued**):**

- Together Mike and Mildred have a combined $2,000,000 generation-skipping tax exemption.
- Divided among three children, this suggests that $667,000 of each child's inheritance would be "exempt" for federal generation-skipping purposes.

CREATION OF EXEMPT TRUST

EXAMPLE 2–25:

- The common alternative, then, is to provide that upon the death of the transferors, the $920,000 net inheritance is divided into an exempt amount of $667,000 (that is, the amount to which is allocated part of the combined $2,000,000 GST exemption) and a non-exempt amount of $253,000.
- The $667,000 amount (in this family of three children) is placed in an Exempt Trust for a child.
  - These funds may be available to the child as noted below.
- From a federal tax perspective, the key is that the principal of the Exempt Trust is not subject to federal estate tax or federal generation-skipping tax in the child's estate.
- If this share of the inheritance had increased to $4,000,000 during the child's lifetime, all $4,000,000 would pass tax-free to the third generation.

Trust Structure — Trustee

Often there is an independent trustee until the child attains a designated age of maturity. The child may be the sole trustee and preserve the "exempt" nature of the trust. That is, even if the child is the sole trustee, the principal of the trust will eventually pass tax-free to the third generation upon the child's death.

Trust Structure — Income and Principal

Commonly the trust provides for the distribution of income and principal for the health, support, maintenance and education of the child and the child's children. From a practical perspective, the income and principal are liberally available to the family. From a federal estate tax perspective, the distribution of principal is subject to the "ascertainable standard" (as later discussed) and so the principal is not subject to federal estate tax in the child's estate.

Trust Structure — Special Power of Appointment

Often there is a special power of appointment permitting the child, by her will, to appoint the property ("sprinkle" the property) among descendants, or among descendants in some larger group. To avoid inclusion in the child's estate as general power of appointment under §2041, the power of appointment cannot be exercisable in favor of the child, the child's estate, the child's creditors, or the creditor's of the child's estate.

NON–TAX ATTRIBUTES OF LIFETIME TRUST

There are a number of non-tax advantages which may attach to a trust which last for the lifetime of the child:

1. Property held in trust generally is protected from the creditors of the child (if the creditor is sued). In some states, this depends on whether the child is the sole trustee and whether the trust permits discretionary distributions of income and principal. Some families establish the lifetime trust with the child as the sole trustee. If the child is sued, the child may resign and appoint a successor independent trustee. In a number of states this is a successful approach for keeping the trust estate beyond the reach of the child's creditors.
2. Property held in trust may also be protected in the context of divorce. Property in trust generally retains its character as the beneficiary's "separate property." In most states, when property is distributed pursuant to a divorce, the property is first divided into "separate property" and "marital property." Each person's "separate property" is beyond the reach of the divorcing spouse. It is the "marital property" which is divided equitably. Again, in some states, the characterization of property held in trust as "separate property" may depend on whether the child is the sole trustee and whether the trust permits discretionary distributions of income and principal. With proper planning, the lifetime trust can be a way to shield a child's inheritance from the reach of a divorcing spouse.

INVESTMENT STRATEGY

Because the assets in the Exempt Trust will not be subject to federal transfer tax upon the death of the child, it is generally sensible to allocate the **appreciating** assets to the Exempt Trust and the **non-appreciating** assets to the Non-Exempt Trust. These are the same issues discussed earlier in this chapter with respect to funding the Credit Shelter Trust.

EXAMPLE 2–26:

- Assume Mike and Mildred transferred $920,000 (net of federal estate tax) to Tim:
  - $667,000 in the Exempt Trust and $253,000 in the Non-Exempt Trust.

(continued)

EXAMPLE 2–26 (continued)**:**

- To the extent that the trustee (who may be Tim) pursues a diversified investment strategy, the trustee would be better served to allocate the bonds and cash-equivalents to the Non-Exempt Trust and the growth stocks or interest in Marvelous Masonry to the Exempt Trust.
- As noted, if the $667,000 in the Exempt Trust increased in value to $4,000,000 during Tim's lifetime, all $4,000,000 would pass to Tim and Laura's children (or other beneficiaries) free of federal estate tax and free of federal generation-skipping tax.

IMPORTANT APPLICATIONS

SINGLE PARENT

Most of the illustrations in this chapter have been presented in the context of two parents preparing their estate plan. Obviously, this planning using the $1,000,000 GST exemption (and an Exempt Trust for each child) can be an important tax-saving technique for a single parent.

EXAMPLE 2–27:

- Consider a single parent, Chris, with an estate of $1,800,000 (net of federal estate tax) and two children.
    - The older child, Annie, is a securities lawyer and is married to an accountant.
    - The younger son, Nick, is a third-year medical student with interests in surgery.
- This would be a classic circumstance in which the single parent might provide by will that the $900,000 inheritance of each child would be divided into an Exempt Trust (holding $500,000) and a Non-Exempt Trust (holding $400,000).
- It is possible that at least one of the children might invest and reinvest the $500,000 in the Exempt Trust and never draw down the funds during the child's lifetime.
    - It is plausible that the $500,000 might increase to $2,500,000 during the child's lifetime.
    - Annie and her husband, for example, might use their own earnings for purposes of raising the family and household expenses.
- If single parent Chris transferred the $500,000 outright to Annie, then the eventual $2,500,000 would attract a federal estate tax of more than $1,200,000.
- By using her $1,000,000 GST exemption and creating an Exempt Trust for each child, single parent Chris can make significant inter-generational federal tax savings.

Parents of Client

Frequently, the clients who are the focus of the planning situation are a middle-aged couple with significant assets and several children. It is proper to focus on their wills, trusts, gift programs, insurance trust, and generation-skipping trusts which will reduce the federal estate tax and the federal generation-skipping tax on the transfers from the middle-aged couple to their children and grandchildren. It is also important, however, to inquire as to the financial circumstances of the **parents** of the couple.

EXAMPLE 2–28:

- If the couple has a net worth of $3,000,000 and if the wife is expected to inherit $750,000 from **her parents**, then the couple should be advised as to the significant tax-saving advantages of the $1,000,000 GST exemption.
- Subject to family and "political" considerations, the wife may want to advise her parents to amend their estate plan — so that her $750,000 inheritance will pass to her in an Exempt Trust.
- Following the mainstream approach, this Exempt Trust would provide that the wife would be sole trustee, that income and principal distributions would be available to her and her family for health, support, maintenance, and education, and that she would eventually have the flexibility to allocate the property by a testamentary special power of appointment.
- The transfer of the wife's $750,000 inheritance in an Exempt Trust would mean, of course, that these funds would not be added to the $3,000,000 net worth of the client couple and, consequently, be subject to tax in their estates.

Chapter 3

Insurance Planning

FEDERAL ESTATE TAXATION

SECTION 2042

- Section 2042 explicitly taxes life insurance.
- The value of the gross estate includes the value of all property:
  - Receivable by the executor as insurance from policies on the life of the decedent.
  - Receivable by other beneficiaries from insurance policies on the life of the decedent if the decedent possessed at death any of the incidents of ownership, exercisable alone or in conjunction with any other person.

INCIDENTS OF OWNERSHIP

- The term "incidents of ownership" is described in Reg. §2042-1(c)(2):

  > For purposes of this paragraph, the term "incidents of ownership" is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan or to obtain from the insurer a loan against the surrender value of the policy.

BUSINESS INSURANCE

- The Regulations at §20.2042-1 provide:
  1. To the extent the proceeds of life insurance on a shareholder's life are payable to or for the benefit of the corporation, the corporation's incidents of ownership will not be attributed to the insured/shareholder.
  2. In the situation described in Rule 1, the insurance proceeds will be taken into account in valuing the corporate stock included in the decedent's gross estate.
  3. To the extent that proceeds of life insurance on a shareholder's life are not payable to the corporation, the corporation's incidents of ownership will be attributed to the insured/shareholder if she is a "sole or controlling" shareholder.

4. The decedent will be considered a controlling shareholder only if, at the time of death, the decedent owned more than 50% of the voting power of the corporation.

EXAMPLE 3–1:

- Assume Russell and Feldstein own 45% and 55%, respectively, of the voting stock of RF Enterprises Corporation which owns the following policies:
  - Policy on Russell's life, payable to the Corporation.
    - The proceeds will affect the valuation of the Corporation in Russell's estate but will not be included directly in Russell's gross estate (unless there is a governing buy-sell agreement which provides otherwise).
  - Policy on Feldstein's life, payable to the Corporation.
    - Proceeds will affect the value of the Corporation in Feldstein's estate but will not be included directly in Feldstein's gross estate (unless there is a governing buy-sell agreement).
  - Policy on Russell's life, payable to spouse.
    - Policy proceeds will not be included in Russell's gross estate.
  - Policy on Feldstein's life, payable to spouse.
    - Policy will be included in Feldstein's gross estate.

INCOME TAX CONSEQUENCES

While the proceeds of a policy on a non-controlling shareholder are not included in the gross estate of the shareholder, the IRS has from time to time successfully argued that the corporate-owned insurance payable to a personal beneficiary results in dividend treatment (either at the time premium payments are made or upon receipt of the insurance proceeds).

KEY PERSON INSURANCE

Key person insurance is insurance owned by a corporation (or other business entity) on a key employee. Generally the insurance is payable to the entity to be used as the enterprise may wish:

- To provide working capital during a period of transition,
- To provide funds for the employment of a successor employee,
- To pay debt, or
- To address a number of business purposes.

Generally the proceeds increase the value of the business and accordingly may affect the valuation of the ownership interests of the insured-decedent. The courts generally make a determination of fair market value by considering a range of factors, primarily with focus on earnings and net asset value. In this context insurance proceeds are sometimes "given consideration" in a court's valuation process. Historically some courts have been willing to discount the value of stock to reflect the loss of the decedent to the corporation.

The I.R.S. position on this issue is set forth in substantial measure in Rev. Rul. 82-85:

> Issue: What are the estate tax consequences when proceeds of a life insurance policy on a decedent's life are payable to a wholly owned corporation of the decedent and then to the decedent's estate pursuant to a stock redemption agreement?
>
> Holding: The proceeds in a life insurance policy on the decedent's life should be reflected in the valuation of the decedent's corporate stock, which is included in the decedent's gross estate under §2033 of the Code. The insurance proceeds are not separately included in the decedent' gross estate under §2042.

NOTE:

- A similar conclusion—that insurance payable to an entity should properly be taken into account for federal estate tax purposes only to the extent it affects the valuation of the decedent's interest in the entity—is set forth with respect to a partnership in *Knip Estate v. Commissioner*, 25 T.C. 153 (1955). The IRS acquiesced to this point of view in Rev. Rul. 83-147. Generally then, the rules with respect to inclusion in the gross estate and valuation are parallel for corporate, partnership (and LLC) entities.

USES OF LIFE INSURANCE

PROVISION OF RESOURCES

One classic purpose of life insurance (whether or not the insured is the owner of a closely held business) is to provide resources for the insured's family in the event of death.

EXAMPLE 3–2:

- With respect to Plumbing Perfection, Inc., the annual livelihood of the family is based primarily on Don's earnings in the business.
- It is not likely that the disposition of equipment and plumbing equipment would produce substantial funds for Don's family.
- With young children, Don and Patricia face the continuing costs of child-rearing and education, life insurance may be well-advised to provide "family funds."

PAYMENT OF DEBT

In addition to needing "family funds," a closely held business may have outstanding debt and/or need working capital. Without the skill and services of the owner, the closely-held business may not be able to generate sufficient revenues for the payment of debt. Life insurance may be necessary to sustain the operation of the business.

PROVIDE FOR EQUALIZATION IN THE FAMILY

A third issue—equalization within the family—is less commonly recognized.

EXAMPLE 3–3:

- Mike and Mildred and Marvelous Masonry provide a classic example in this regard.
- Mike and Mildred have an estate of approximately $3,500,000 of which the business represents approximately $2,500,000.
- Assume that Mike and Mildred both died in 2003 (when the unified credit is $700,000) with Credit Shelter Trust type wills.
    - $1,400,000 would be shielded from federal estate tax.
    - The balance of $2,100,000 would attract federal estate tax at rates of approximately 45%. The federal estate tax would be approximately $950,000.
    - If the residence and investment assets were sold, the resulting assets for distribution would be the business with a value of $2,500,000 and other assets with a value of $50,000.

DISCUSSION:

- This is the classic dilemma.
- If the business is distributed to son Tim, who operates the business, Tim has an inheritance of $2,500,000 and each of the daughters has an inheritance of $25,000.

Alternatively:

a. The estate may be distributed in one-third pro rata shares. Each child receives 33% of the stock in the business and $17,000 in other assets. Anne and Barbara together control the business.

(continued)

EXAMPLE 3–3 (continued)**:**

b. Same as (a) above but Marvelous Masonry is recapitalized so that Tim has all the voting stock.

- Even though Anne and Barbara each inherit $833,000 of stock in Marvelous Masonry, it will probably be a "paper inheritance."
- Tim will earn a salary, be covered by health insurance, and have an array of corporate benefits.
- Assuming Marvelous Masonry pays no dividend (and that is the case with most closely held businesses), Ann and Barbara receive no significant "spendable inheritance."

SECOND–TO–DIE POLICY

There may be a number of factors which suggest the advisability of purchasing a first-to-die life insurance policy for the owners of a closely held business. For Marvelous Masonry and Splendid Sod particularly, it may also be advisable to purchase a second-to-die life insurance policy. This policy, payable upon the death of the survivor of the two insured persons, may provide substantial cash liquidity to pay federal estate tax, to reduce debt, and to help provide for family equalization.

EXAMPLE 3–4:

- Indeed, it may be that a family with a closely held business may purchase some first-to-die life insurance on the owner's life and some second-to-die insurance.
- Notwithstanding an estate of $3,500,000 (Marvelous Masonry at $2,500,000 and other assets at $1,000,000), Mildred may not have substantial income if she is the survivor.
  - Mildred does not work in the business and Marvelous Masonry pays no dividend.
  - The $1,000,000 of other assets is largely made up of the residence.
- A first-to-die policy on Mike's life can provide funds for Mildred's period of survivorship.
- When both Mike and Mildred die, there will also be an insurance need.
  - The federal estate tax could be as high as $1,000,000.
- Additionally, life insurance could play a key role in helping to equalize the estate distribution and provide a "spendable inheritance" for Anne and Barbara.
- To reiterate, then, Mike and Mildred would be well-served to consider the purchase of some first-to-die life insurance on Mike's life and some second-to-die insurance.

SPLIT–DOLLAR LIFE INSURANCE

To provide financing for life insurance, one should consider a split-dollar arrangement.

EXAMPLE 3–5:

- Let's consider the possibility of financing a $1,000,000 policy on Mike's life for the business Marvelous Masonry.
- A $1,000,000 policy on Mike's life has an annual premium of $26,000.
- In a traditional split-dollar arrangement, the Company agrees to pay the "permanent insurance" component of the premium and the employee pays the "term component" of the premium.
    - This term component is equal to the PS 58 cost. (Alternatively the Company may also agree to pay the "term component" of the premium which then represents taxable income to the employee.)
- Generally, and advisably, this arrangement is set forth in a written Split-Dollar Agreement.
    - Typically the Split-Dollar Agreement provides that the employee, Mike, is the owner of the policy.
    - The owner is entitled to receive the insurance proceeds upon the death of the insured.
- The Company, Marvelous Masonry, effectively "advances" the necessary funds each year to pay the premium (at least the "whole life component" of the premium).
    - Upon Mike's death, his estate is obligated to repay to Marvelous Masonry the advances without interest.
- The "advances" by the Company are, in effect, interest-free loans.
- The Split-Dollar Agreement remains a distinctive exception to the rules otherwise set forth in I.R.C. §7278 (requiring imposition of interest in family estate planning and business planning transactions).

The split-dollar arrangement may accomplish several goals by providing:

- Important fringe benefits and incentives to a valued employee.
- Method of obtaining life insurance at a reduced cost to the employee (by using employer funds).
- Reduction in use of the annual exclusion or unified credit if the employee transfers ownership of the life insurance policy to an ILIT.

- Because the company is paying most of the premium, the employer is paying a much smaller share of the premium and hence the employee's "premium gift" to the irrevocable insurance trust is smaller.

Typically the "advances" by the company are secured, either through the endorsement or collateral assignment method.

Collateral Assignment Method

Under the collateral assignment method, the policy is owned by the employee (or a third party such as an irrevocable life insurance trust).

- The employer's interest in the policy, such as the right to recover its aggregate premium payments, is contained in a collateral assignment of the policy by the owner to the employer specifying these rights.

Endorsement Method

Under the endorsement method, the policy is owned by the employer and the employee's rights are contained in a split-dollar endorsement.

- In a traditional split-dollar plan, for example, the endorsement would give the employee, as subowner, only the right to name the beneficiary of the death proceeds in excess of the employer's interest in those proceeds.

On balance, especially in the case of split-dollar on shareholder-employees, the collateral assignment method of security predominates.

Income Taxation of Split Dollar

The income tax treatment of traditional split-dollar plans is explained in Rev. Ruls. 64-328, 66-110 and 67-154.

- The employee includes in gross income the value of the economic benefit he receives which would be the cost of one-year term insurance in an amount equal to the employee's share of the death benefit less any contribution made by the employee.
  - The one-year term costs are commonly referred to as the PS 58 rates.
- The employee does not include in gross income the annual "loan" made by the employer each year.
- The employer is not entitled to any deduction for its share of the annual premiums since it is "directly or indirectly a beneficiary under such policy" within the meaning of IRC § 264.

- The death benefits received by the employer and the employee are exempt from income taxation.

ROLLOUT

When the split-dollar agreement is terminated other than by the insured's death, the employer is repaid its investment in the policy by the employee and its interest in the policy is released ("rolled out").

EXAMPLE 3–6A:

- Sally Anderson enters a split-dollar agreement with her employer, Computer Bonanza, to purchase a whole life policy.
  - Sally retires 15 years later.
  - Computer Bonanza's interest in the policy is $370,000 (its cumulative premium outlay).
- Upon roll-out, Sally pays $370,000 to Computer Bonanza and the Company releases its assignment in the policy.
- Sally now owns the entire policy.

Reasons for Rolling Out

There are several reasons for "rolling out":

- The employee retires.
- The economic benefit cost (single life PS 58) becomes too expensive.
- The employee is concerned about the taxation of equity (discussed below) and wants to terminate the split-dollar plan before the cash value exceeds the employer's cumulative premium outlay.

In the collateral assignment system, the employer releases its assignment of rollout in exchange for a payment equal to its cumulative outlay where the cash value of the policy exceeds the outlay. Has the employer transferred an interest in the policy for valuable consideration? It appears it has, however the "pledging or assigning of collateral security is not a transfer for a valuable consideration of such policy or an interest therein under §101 and accordingly the transfer for value regime is inapplicable to any amounts received by the pledgee or assignee."

DEFERRED COMPENSATION

Often, given the contemplation of roll-out, a deferred compensation arrangement is structured along with the termination of the split-dollar agreement. When the split-dollar contract is signed, Computer Bonanza also signs a deferred compensation agreement that will pay Sally, as deferred compensation, the amount of the "accumulated advances."

In such planning modes, the deferred compensation is usually "grossed up" so that it includes the amount necessary to pay the income tax on the deferred compensation.

EXAMPLE 3–6B:

- In the above example, Sally would receive deferred compensation in the 15th year of \$620,000, including \$370,000 to pay off the advance debt and \$250,000 to pay the associated income tax on the deferred compensation.

PRIVATE SPLIT DOLLAR

While split dollar has traditionally been used in employer-employee transactions, it is now being considered as a method for family or "private" relationships. Survivor or second-to-die insurance is the product of choice to use with split-dollar funding. Two family members, or a family member and a trust, split the ownership of the policy. This provides flexibility in determining the sources of funds to pay life insurance premiums and in the ability to leverage the \$10,000 annual gift tax exclusion.

Some commentators have taken the position that these arrangements do not appear to be governed by the employment-related arrangements rules because they do not provide a "similar" benefit to the donee as provided the employee under an employment-related arrangement. These commentators argue that the interest-free loan rules of §7872, rather than the "economic benefit" concept of Rev. Rul. 64-328, would appear to apply to determine the gift tax (and potential income tax) implications of these arrangements.

If §7872 were to apply to private split-dollar arrangements, not only would the measure of the gift change from the "economic benefit" to the forgone interest but the premium provided would have income to report from the transaction and the premium recipient would have a potentially unusable deduction based on the forgoing of interest. This would be a severe result.

On the other hand, some commentators have argued that the life insurance benefit is the same as that provided the employee in an employment setting. Accordingly, these commentators argue that the gift to the donee should be measured by the Rev. Rul. 64-328 concept.

There is authority supporting the use of private split-dollar programs. In Private Letter Ruling 9636033, for example, an individual life policy insuring the husband was split-dollared between his wife and an insurance trust. The trust paid the annual term cost and the wife paid the balance of the premium. The trust collaterally assigned the policy to secure her premium advances.

In private letter ruling 9636033, the IRS held that the wife's premium payments were not gifts since she was entitled to reimbursement of those amounts, although the ruling contained the IRS "standard §7872 disclaimer." It further held that the proceeds payable to the trust were not includable in the insured husband's estate because he possessed no incidents of ownership in the policy.

In addition, the ruling concluded that the arrangement had no estate or income tax consequences to either party—again on the explicit assumption that the interest-free nature of the payment of the advances had no tax consequences to the spouse as a trust beneficiary. Finally the ruling held that since there was no employment relationship the insured had no income tax resulting from the arrangement.

Notwithstanding this authority (and others), private split dollar remains a generally untested and aggressive approach.

[This explanation (but not the conclusion that private split-dollar is an untested and aggressive approach) is taken largely from London and Kreisberg, "Split-Dollar Life Insurance, An Old Friend with New Wrinkles," *Trusts and Estates*, March 1999.]

RELATED ISSUES

Corporation Provides Funds for Premium Payment

One advantage of a traditional employer-based split-dollar arrangement, at least in the short term, is that the corporation (or business entity) provides the funds for the payment of the premium.

- In a C corporation particularly, there is an income tax saving in the short run because it is not necessary to distribute cash to the shareholder-employer (taxable as compensation or as a dividend) to provide after-tax funds for payment of the "whole life component" of the premium.

Income Tax Risk

In TAM 9604001, the National Office asserted that the cash surrender value in an equity split-dollar insurance policy that exceeds the amount returnable to the employer is current taxable income to the employee.

- That is, if the cash surrender value in a policy exceeds the amount of the "advance" by the employer, this difference represents taxable income to the employee-insured.

- For a traditional permanent insurance policy, the cash surrender value of the policy in later years increases each year by substantially more than the amount of the premium.

- To reiterate, TAM 9604001 suggests that the difference becomes taxable income to the insured-employee.

Ownership by Irrevocable Insurance Trust

In many circumstances, and this would be the case for a split-dollar agreement in the Marvelous Masonry setting, the insured-shareholder may establish an irrevocable life insurance trust to own the policy.

- In this arrangement, the split-dollar agreement is a contract between the company (Marvelous Masonry) and the irrevocable insurance trust (established by Mike as settlor).
  - The insurance trust owns the policy.
  - The company agrees to pay the "whole life component" of the premium each year.
  - The insurance trust agrees to pay to the company from the eventual life insurance proceeds the outstanding advance loan.
- In this mode, the insured-shareholder may make a gift each year to the life insurance trust — in an amount necessary to pay the "term insurance component" or PS 58 cost.

When the policy is owned by an irrevocable insurance trust, one additional advantage is that the split-dollar structure reduces the gift required by the insured-shareholder to the insurance trust. This has been previously noted.

- If there were no split-dollar arrangement, the annual gift required by the insured-shareholder to the insurance trust would be substantially larger and could chip away at the unified credit or result in a gift tax ($26,000 for the premium on the $1,000,000 policy in the Marvelous Masonry example).
- In a split-dollar arrangement, at least for the short term, the irrevocable insurance trust is required to pay the much smaller "term insurance component" of the premium and so the required gift (by the insured-shareholder to the insurance trust) is much smaller.
- Accordingly a split-dollar arrangement, in reducing the value of the gift, may make it possible to keep the gift within the $10,000 annual exclusion amount or otherwise preserve unified credit protection.

This advantage noted above may essentially be a deferral.

- If the policy is owned by an insurance trust, then there must be a large gift to the insurance trust upon roll-out.
  - Upon roll-out the insurance trust must repay the "advances" to the company.

- In order to have funds for this payment, the insured-employee (Mike) must make a large gift to the insurance trust.
- Typically it will require use of the unified credit—to shield the gift of funds to the insurance trust from federal gift tax.

Reverse Split Dollar

Under a reverse split dollar, the traditional roles of the employer and the employee are reversed.

- The employee owns the policy and endorses an interest in the insurance benefit to the employer for a limited period of time.
- The employee owns the cash value and the employer is the beneficiary of the term or "at risk" portion of the death benefit.

In reverse split dollar, the employer usually funds most of the premiums and the employee receives a substantial cash value at retirement. Each year the employer contributes the PS 58 cost which is based on an old (and expensive) mortality table and therefore represents a significant share of the premium. In effect, the economics are such that the employee pays the "permanent insurance component" of the premium but receives a substantial increase in cash value, beyond the increase which would ordinarily attach to a policy. The employer pays a "high" term cost and effectively transfers cash value to the employee's ownership of the policy. There is, in effect, a shift of financial value from the employer to the employee (by the employer's payment of the "high" term premium) without that shift constituting taxable income.

OWNERSHIP CONSIDERATION — ESTATE TAX

MODERATE ESTATE

Whether the owner of the closely held business should own the life insurance policy (as opposed, for example, to an irrevocable life insurance trust) may depend on the value of the owner's estate.

EXAMPLE 3–7A:

- In Plumbing Perfection, Don and Patricia have a total estate, independent of life insurance, of approximately $800,000.
- Assume Don considers the purchase of a $500,000 life insurance policy on his life.
- If Don dies as owner of the policy, the proceeds may pass to Patricia with no federal estate tax.

(continued)

EXAMPLE 3–7A (continued)**:**

- If Don and Patricia together have adopted estate planning with a Credit Shelter Trust as described in Chapter 2, there will be no federal estate tax on Don's death and likely no federal estate tax on Patricia's subsequent death.
- With the eventual increase of the unified credit to $1,000,000, it will be possible by 2006 for Don and Patricia together to transfer $2,000,000 to the children free of federal estate tax.

EXAMPLE 3–7B:

- By contrast, Mike and Mildred with Marvelous Masonry have an estate in excess of $2,000,000, independent of life insurance.
- If Mike purchases a $1,000,000 policy, those proceeds will ultimately be added to the estate.
  - Even if Mike and Mildred adopt planning with a Credit Shelter Trust and both survive until at least 2006, they can only shield $2,000,000 of assets from federal estate tax.
  - The additional $1,000,000 of life insurance (or the reinvestment proceeds) will eventually attract federal estate tax, generating federal estate tax of at least $450,000.
- It would be advisable for Mike and Mildred to consider ownership of a life insurance policy by an irrevocable life insurance trust.
- Ownership of a new $1,000,000 policy **by Mildred** may not solve the federal estate tax problem.
- Assume that Mildred purchases a $1,000,000 policy on Mike's life and Mike dies.
  - The $1,000,000 paid to Mildred will not be subject to federal estate tax but the proceeds increase Mildred's estate.
- The federal estate tax result is identical to that which would result if Mike owned the $1,000,000 and Mike died first.
- The $1,000,000 policy (or the reinvestment proceeds) will eventually be subject to federal estate tax (if Mike dies first).
- To reiterate, Mike and Mildred should consider ownership of the new $1,000,000 policy by an irrevocable life insurance trust.

Ownership by Children

Another planning alternative is for the $1,000,000 life insurance policy on Mike's life to be owned by the children, namely Tim, Ann, and Barbara.

This planning can sometimes accomplish tax saving and meet desired family goals, but the children's ownership of the life insurance policy has several qualifications:

- **Young Children**

  This strategy may not work well if the children are young. Assume the business owner's children are 18 and 20, respectively. Is it good estate planning for substantial cash proceeds to pass outright to each child at that age?

- **Needs of Surviving Spouse**

  In the example of Marvelous Masonry, if Tim, Ann, and Barbara own the policy, the proceeds pass to them, **not** Mildred. One of the reasons for life insurance coverage is to make funds available to the surviving spouse. If the policy is owned by the children, the proceeds are not available for the surviving spouse. If the children own the policy and name Mildred as the beneficiary, there is a $1,000,000 (potentially taxable) gift by the children to Mildred on the death of Mike.

- **No Generation-Skipping**

  If Tim, Ann, and Barbara own the policy outright, it is not possible to structure the ownership arrangement in generation-skipping trusts (so that proceeds would eventually escape estate taxation in the respective estates of the children).

Ownership by Partnership

It may be advantageous if a partnership owns Mike's life insurance policy. This partnership may be a limited partnership in which Mildred is a 4% general partner and Tim, Ann, and Barbara are each 32% limited partners.

Advantages

This planning has two advantages:

- **Control**

  Mildred, as the general partner, can control the investment and expenditure of the proceeds.

- **Tax Saving**

  Only 4% of the value of the partnership assets will be included in Mildred's taxable estate upon her later death.

This planning has the continuing detriment that only 4% of the funds are available to Mildred for her health, support, and well-being.

Ownership of life insurance by a partnership may be more sensible if the children are older and if the family is seeking a mechanism for the simplified ownership of a large policy. It may be particularly suitable when the insurance policy is purchased to provide liquidity for the payment of federal estate tax on the second estate rather than to provide funds for the surviving spouse.

IRREVOCABLE LIFE INSURANCE TRUST

PLANNING TECHNIQUE

The mainstream planning device to avoid taxation of life insurance proceeds is to have the policy owned by an irrevocable life insurance trust (ILIT).

EXAMPLE 3–8:

- Mike establishes an ILIT.
    - The ILIT provides that if Mike dies and Mildred survives, the proceeds will be held (and invested) in the ILIT.
- The income and principal of the ILIT will be available for the health, support, maintenance, and education of Mildred, Tim, Ann and Barbara.
- Mildred will be the sole trustee and she will also have a testamentary special power of appointment over the ILIT exercisable among Mike's descendants.
- If Mike dies, the ILIT works much like a traditional Credit Shelter Trust and may be structured identically to a Credit Shelter Trust.
    - The funds are wholly available for the health, support, maintenance, and education of the family but are not included in Mildred's estate for estate tax purposes.
- Even with the increase in the unified credit amount, the maximum that can be transferred to a Credit Shelter Trust in 2006 is $1,000,000.
- For an ILIT, the maximum that can be held in the trust, protected from estate tax in the survivor's estate, can be much more.
- If Mike's ILIT were to purchase a $20 million term life insurance policy, all $20 million would pass free of federal estate tax to Mildred and then again free of estate tax to Tim, Ann, and Barbara.
- The associated estate tax saving resulting from an ILIT can be very substantial.

TRUSTEE

The insured person may not be the trustee of the ILIT. If Mike established an ILIT and named himself as trustee, the proceeds would be included in his gross estate (§ 2036—because Mike had retained a right of control).

EXAMPLE 3–9:

- There is no "spousal unity" for purposes of §2036.
- Mike can establish an ILIT and name Mildred as the original trustee.
  - Mildred will be the trustee during Mike's life.
- Assuming Mildred survives Mike, Mildred can continue to be the trustee without causing inclusion of the trust assets in her estate.
  - This follows the substantially identical rules which govern a Credit Shelter Trust:
    - Mildred may be the sole trustee of the Credit Shelter Trust established under Mike's will, with the income and principal available for her health, support, and maintenance, without causing inclusion of the trust assets in her estate at her later death.

PURCHASE OF ASSETS FROM THE ESTATE

Using life insurance for estate planning purposes provides liquidity to an estate for the payment of taxes and other expenses. The terms of the ILIT will typically provide that the trustee of the ILIT may purchase assets from the estate of the insured at fair market value, thus providing the estate with cash needed for the payment of taxes. The ILIT continues after this transaction, now holding assets purchased from the estate. In an ILIT established by Mike, the ILIT might purchase from Mike's estate shares in Marvelous Masonry.

The purchase of the assets from the estate generally does not trigger taxable gain to the estate (on the sale of the assets to the ILIT) because the assets have received a step-up in basis at the insured's death. Ordinarily the ILIT does not end with the death of the insured. Typically, it continues either as a trust for the surviving spouse or is divided into separate trusts for the children.

INTER–GENERATIONAL TRANSFER

Typically a parent will transfer his estate to children. This inter-generational transfer may occur upon the death of a single parent or upon the death of the survivor of two parents. For Marvelous Masonry, Plumbing Perfection and Splendid Sod, the owners are all married couples. Most of the value of the closely held business and other family assets will pass to the second generation upon the death of the surviving parent.

Upon the death of the surviving parent, cash funds may be needed to accomplish the following:

- Pay the federal estate tax.
- Pay business debt or otherwise provide working capital.

GENERATION–SKIPPING PLANNING

As noted, life insurance can be described as an appreciating asset. The tax planning associated with an irrevocable life insurance trust can be quite powerful.

EXAMPLE 3–10:

- Mike established an ILIT which purchased a $1 million policy on his life.
  - The annual premium was $7,500.
- If the ILIT was structured with traditional Crummey withdrawal rights, and if Mike died shortly after the policy was purchased, the family would have effectively positioned $1 million for eventual transfer to the second generation free of federal estate tax.
- This "positioning" would have been accomplished using only $7,500 of annual exclusion protection.

Given the "appreciating" nature of life insurance, it is often advisable to structure an ILIT as a generation-skipping trust. The ILIT would provide:

> *Upon my death if my spouse, Mildred, survives me, the trustee shall hold the trust estate for my spouse and my descendants. The trustee shall distribute income and principal to any one or more of my spouse and my descendants as the trustee determines to be necessary or advisable to provide for health, support, maintenance, and education. Upon the death of my spouse, the trust estate shall be divided into shares for my descendants then living, by representation. Each share shall be held in trust for the descendant. The descendant shall be the sole trustee of the trust. The trustee shall distribute income and principal to such descendant and his/her descendants as the trustee may determine to be necessary or advisable to provide for health, support, maintenance, and education.*

> *This trust for my descendant shall terminate upon the death of the descendant. Upon termination such descendant shall have a testamentary special power of appointment exercisable among my descendants. If such descendant does not exercise such testamentary special power of appointment, the remaining trust estate shall be distributed to such descendant's then living descendants, by representation.*

BENEFIT

There may be substantial benefit from structuring the ILIT as a generation-skipping trust. Not only will the proceeds and associated investment assets eventually pass free of estate tax to the second generation, the investment assets will eventually also pass free of estate tax to the third generation.

Chapter 4

Buy–Sell Agreements

BUY–SELL AGREEMENTS—INTRODUCTION

For the owner of a closely held business, the disposition of that business at the owner's death represents the heart of the owner's estate planning. Chapter 2 and Chapter 3 describe traditional testamentary planning to maximize the **value** of assets passing to the decedent owner's family. For a married owner of a closely held business, planning to capture the decedent owner's applicable credit amount can reduce the eventual federal estate tax. Further, the purchase of life insurance, and particularly the ownership of life insurance in an irrevocable life insurance trust can provide tax-free funds to the family. However, these two techniques do not necessarily govern what happens to **ownership** and management of the business upon the death of the owner. In some cases such as Spectacular Sod, it may be that ownership of the closely held business will pass into trust for the surviving spouse and eventually in equal shares to the children, with no sale of any interests. For other families, death of the owner of the closely held business may trigger sale of the interests, either within the family (such as a sale of Marvelous Masonry stock by daughters Ann and Barbara to son Tim) or sale to an outsider (such as a sale of Plumbing Perfection to key employee, Jack).

Closely held and family businesses are a significant part of the U.S. economy accounting for over 50% of the Gross National Product and more than 65% of all wages. Family businesses succeed but notably relatively few survive beyond the "founder generation." Less than 30% of closely held businesses make it to the second generation and less than 13% make it to the third generation. If there is to be a successful transition to the next generation, it is imperative that there be careful planning which focuses on the estate planning structure, the economics of the business, and a realistic assessment of the business skills (and weaknesses) of the second and third generation family members. Richard A. Vaughn, C.L.U., in his article, "Overcoming the Psychological Difficulties in Business Succession Planning," suggests the following nine questions to ask the founder:

1. Does anyone else in the family really want the business?
2. Can the business really survive without you?
3. Are there clear lines of separation between ownership and management?
4. Is the business structured to allow for the changes brought about by succession?
5. Have you personally planned for a change in your role in the business?
6. Have you and your spouse properly planned your own retirement for your lifestyle needs?

7. What will be the costs and disadvantages arising from the changes in ownership and management?
8. Is your estate plan properly arranged to mesh with the business continuation plan?
9. Are you prepared to do something about the business succession now?

BUY–SELL AGREEMENTS—TYPE

CROSS–PURCHASE AGREEMENT

A buy-sell agreement structured as a cross-purchase agreement is one in which the owners of the business buy the interest in the company. The company is not a party to the agreement.

EXAMPLE 4–1:

- Consider ABC Company which is owned by Chris, Terry and Sean, each of whom owns $33^1/_3$% of the stock.
- If Sean dies, Chris and Terry may not want Sean's spouse as a continuing stockholder.
  - They may want the freedom to go forward with their vision of the company's future.
- Chris and Terry may want to bring in another principal, transferring a $33^1/_3$% ownership in the ABC Company to the new investor/principal.
- Similarly, Sean may not want his family to hold a $33^1/_3$% interest in ABC Company for a continuing period after his death.
  - Typically, a closely held business pays a minimal dividend (if any).
- The value associated with Sean's $33^1/_3$% ownership interest may not generate cash income for the health, support, and maintenance of Sean's family.
  - Further, Sean may not want his family to participate in the business risks and ventures pursued by Chris and Terry after Sean's death.
- With these motivations, Chris, Terry, and Sean may sign a cross-purchase agreement.
  - Sean would agree, for example, that if he were to die, his estate would sell 50% of his stock to Chris and 50% of his stock to Terry.
- In the buy-sell agreement, Chris would assume the legal obligation to buy such 50% and Terry similarly would assume the obligation to buy 50%.
- To reiterate, the ABC Company would not be a party to the agreement.

(continued)

EXAMPLE 4–1 (continued)**:**

- Obviously the funds for the respective purchases by Chris and Terry would come from their personal funds and not from the company (unless there were some borrowing arrangement or future compensation or future dividends).
- Indeed, Chris and Terry generally have three possible sources of funds to use in the purchase of Sean's stock:
  1. Personal resources
  2. Funds distributed from the company, by way of a loan or taxable compensation or taxable dividends.
  3. Insurance (for example, Chris may own a life insurance policy on Sean's life).
- It is notable in a cross-purchase agreement that the purchaser (Chris or Terry) receives a basis in the stock purchased from Sean's estate equal to the purchase price (conversely in a redemption- type agreement, the surviving owners—Chris and Terry—see no change in the basis of their stock interest in the ABC Company).
- Typically Sean's estate does not realize any taxable capital gain on the sale of the stock pursuant to the cross-purchase buy-sell agreement because Sean's estate receives a step-up in basis with respect to Sean's stock.

It should be mentioned that a cross-purchase agreement works best when there are only two or three owners of the closely held business. For a company with five or six or more owners, a cross-purchase buy-sell agreement is quite complex. The drafting of the legal document is tedious and hence often expensive. The cross-purchase arrangement itself is complicated.

If a cross-purchase buy-sell agreement is funded with life insurance policies, the number of policies can become burdensome. For a company with three owners, there would ordinarily be six policies issued:

Necessary Life Insurance Policies:

1. Chris owns a policy on Terry's life
2. Chris owns a policy on Sean's life
3. Terry owns a policy on Chris' life
4. Terry owns a policy on Sean's life
5. Sean owns a policy on Chris' life
6. Sean owns a policy on Terry's life

For a company with seven owners and a cross-purchase agreement funded with life insurance, there would be 42 different life insurance policies required. Obviously this would constitute a significant administrative burden.

The tax effects of a cross-purchase agreement may include the following:

- The life insurance on the decedent owner's life owned by a surviving owner is not included in the decedent's estate for federal estate tax purposes.

EXAMPLE 4–2:

- The proceeds paid to Chris on Sean's life are not included in Sean's estate.
- Sean has no "incidents of ownership" in the policy which Chris owns.
- Note though that Sean may own policies on the life of Chris and Terry and the value of those policies is includable in Sean's estate.
- Generally the buy-sell agreement provides that Sean's estate has an obligation to sell not only his shares in the ABC Company but also the life insurance policies which he owned on the life on Chris and Terry.

- The funds paid to Sean's estate do not constitute a redemption distribution and accordingly will not be treated as dividends.
- For a deceased shareholder, the interest in the closely held business generally receives a step-up in basis, as noted, so that there is no taxable capital gain upon the sale.
  - If the price paid for the interest is more than its basis (cost), the difference may be taxable at ordinary income rates despite the fact that the assets sold is a capital asset.

REDEMPTION AGREEMENT

In a redemption-type agreement, the corporation (partnership or LLC) agrees to purchase the stock (or interest) of a deceased owner. The company is a party to the agreement. Indeed, the company is the party which would purchase the equity interest upon the death of an owner.

EXAMPLE 4–3:

- Under a redemption agreement the ABC Company would agree that if Chris, Terry, or Sean were to die, the company would purchase the $33^1/_3$% stock ownership interest of the decedent.
- If Sean were to die, Chris and Terry would become 50-50 owners of the company by reason of the redemption of Sean's stock.

(continued)

EXAMPLE 4–3 (continued)**:**

- If the company had 300 outstanding shares prior to Sean's death, the buy-sell agreement would provide for the purchase by the ABC Company of Sean's 100 shares after the purchase.
- Chris and Terry would each continue to own 100 shares of the outstanding 200 shares.
- After the redemption, each would be a 50% owner.

The redemption agreement is generally a more simple approach than the cross-purchase agreement. If life insurance policies were acquired to fund the purchase under the buy-sell agreement, the following number of policies would be required:

1. Three shareholders—three policies (and not six policies as with a cross-purchase agreement).
2. Seven shareholders—seven policies (and not 42 policies as required with a cross-purchase agreement).

From a tax perspective, the following points should be kept in mind:

1. For a redemption agreement with insurance, assuming the company is the owner and beneficiary of the policy, the value of the insurance on the decedent's life will not be part of the decedent's gross estate.
   - Note, though, that the insurance proceeds may be considered a company asset for purposes of valuing the business and thus increase the decedent's value of the business.
   - Whether or not the insurance proceeds are considered an asset for these valuation purposes may be governed by the buy-sell agreement.
2. The most significant potential problem in a corporate stock redemption agreement is that the redemption may be treated as a dividend distribution.
   - Generally distributions in redemption of stock by a corporation will be treated as a dividend (subject to ordinary income taxation to the extent of the corporation's earnings and profits) unless the distribution meets certain exceptions to the general rule.
   - The most common exception is the redemption of all of a shareholders stock (a complete termination of interest) will not be treated as a dividend.
   - This would be the case in a redemption-type agreement with the ABC Company and Chris, Terry and Sean. Such an agreement will provide for the purchase of all of a decedent's stock. (The three business owners are not related. It is significant for

these purposes that the tax treatment may be complicated by the "attribution rules" by which the ownership of one owner may be attributed to another (decedent) owner. In some circumstances it is possible to waive the family attribution rules).

3. As with a cross-purchase agreement, the decedent's estate generally will not realize any taxable capital gain upon the sale, given the step-up in basis.

There will usually be a smaller after-tax combined cost on a corporation that uses a redemption-type agreement (relative to a cross-purchase type agreement). This happens because the purchase monies used by a purchasing business owner under a cross-purchase-type agreement will be subject to tax at the corporate level and at the individual income tax level (unless it is an S corporation). The funds used by a C corporation to satisfy obligations under a redemption-type agreement will have been taxed but only at the corporate level. For a partnership, LLC, or S corporation only one level of income tax will occur in any event.

HYBRID AGREEMENT

Occasionally an agreement will have a hybrid structure. The company may have the right to purchase the shares of a deceased stockholder. If the company does not exercise (or does not completely exercise) its right to purchase, then the right may pass to the underlying shareholders on a pro rata basis. Conversely in some agreements the other owners may have the right to purchase, with the company having a secondary right if the shareholders do not fully exercise their rights of purchase.

BUY–SELL AGREEMENT FOR S CORPORATION

A number of special considerations apply to S corporations:

- An S corporation is not subject to AMT or the dividend treatment of stock redemptions (assuming that the S corporation has no prior C corporation accumulated earnings and profits).
    - Therefore stock redemption agreements may be favored with an S corporation.
- The buy-sell agreement must prohibit transfers to ineligible shareholders, e.g., a non-resident alien.
- The buy-sell agreement must not create a second class of stock (§1361). A corporation that has more than one class of stock does not qualify as an S corporation. In this regard the regulations specifically address buy-sell agreements [Reg. 1.1361-1(L)]. A buy-sell agreement which restricts the transferability of stock will be disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights unless:
    - A principal purpose of the agreement is to circumvent the one class of stock requirement; and

- Agreement establishes a purchase price which, at the time the agreement is entered into, is significantly in excess or below the fair market value of the stock.

Business Continuation for Partnership

Unlike a corporation, if more than 50% of the total partnership and capital and profits are sold within a 12-month period, the partnership is dissolved under §708. However, the regulations under §708 indicate that if the interest of a partner is liquidated rather than sold, there is no dissolution even if that interest exceeds 50%. If the buyout does terminate the partnership, it is treated as having made a pro rata liquidating distribution of all of its assets to the partners, which are then recontributed to the partnership. Both are generally tax-free.

If a partnership buy-sell agreement involves the sale of a partnership interest to other partners (or even a third person, such as an employee), any gain or loss realized by the selling partner is treated as a gain from a sale or exchange from a capital asset, except to the extent that it is attributable to "hot assets" (such as unrealized receivables and substantially appreciated inventory). Note that in the case of a sale of a deceased partner's interest, the stepped-up basis of death will eliminate most of the gain, except that amount attributable to items of income with respect of the decedent owned by the partnership. The purchaser requires the cost basis in the partnership interest in Code §742 and may seek to adjust the basis of the partnership assets to reflect the purchase under Code §§743(b) and 754.

Consideration should also be given to the use of a liquidation plan that meets the requirements of §736, so that part of the payment can take the form of a tax deductible payment that can be spread over a period of several years.

Note that if a buy-sell agreement for a partnership includes life insurance, the receipt of the insurance proceeds increases the income tax basis of the partnership interest of all partners including the interest owned by the decedent. Where insurance on the life of each partner is owned by other partners under a cross-purchase plan, the policies can be transferred between the partnership and partners without fear of the transfer for value rule under §101(a)(2)(B). (This partnership discussion is from *Estate Planning*, Leimberg, et al., editors. Ninth Edition.)

Incentive to Enter Agreement

Owner of Minority Interest

A person who owns an interest in a publicly traded company is well protected. If the person dies, the person's family may sell the interest in the public market for cash. By contrast, if a person owns a minority interest in a closely held business, the person's interest may practically be worth very little if there is no buy-sell agreement.

EXAMPLE 4–4:

- Consider the hypothetical ABC Company described above.
- If Sean dies and there is no buy-sell agreement, Sean's family owns a 33⅓% interest in the company.
- This 33⅓% interest does not entitle any member of Sean's family to employment with the ABC Company nor does it entitle any member of Sean's family to a dividend (and generally there are minimal or no dividends on closely held stock).
- If Sean dies and there is no buy-sell agreement, Sean's family may have a stock certificate which is of no practical value to the family.
- Accordingly, there is almost always a very strong incentive for an owner of a minority interest in a closely held business to enter into a buy-sell agreement—to provide a **guaranteed market** for the minority interest in the event such owner dies.

Majority Owner—Likely Outside Buyer

EXAMPLE 4–5:

- Consider the Talbot Packaging Company.
- It was established in 1976 by John Talbot.
  - The gross sales last year were approximately $5,500,000.
  - The company has 25 employees including five key managers.
  - One of the managers, Jason Morton, owns 10% of the stock.
- During the last several years, John has received a number of unsolicited offers from persons interested in buying the company.
  - Indeed, there has been a substantial consolidation proceeding in the industry over the last several years.
  - Three of the main "consolidating groups" have approached John with respect to purchase.
- In a circumstance such as this, John may decide to enter into a buy-sell agreement, but John's family will be well protected even if John dies without a buy-sell agreement.

(continued)

EXAMPLE 4–5 (continued)**:**

- It is likely that John's family members (or the trustees under John's estate plan) will be able to negotiate a sale to a third party after John's death.
- It **will** likely be possible for John's family to convert the ownership interest to cash (or perhaps cash and a secured promissory note).
- There is not necessarily a compelling incentive for John to enter into a buy-sell agreement.
- Note that Jason Morton does have a strong interest to enter into a buy-sell agreement.
- His position is like that of Sean in the hypothetical example above.
  - If Jason dies, there is no guaranteed market for his shares.

Majority Owner—No Outside Buyer

If there is no likely outside buyer, then even a person who owns a majority interest would want to proceed with a buy-sell agreement.

EXAMPLE 4–6:

- Consider Don, the owner of Plumbing Perfection.
- If Don dies, neither his wife Patricia nor any of the three children may run the business.
- Don's family can sell the plumbing equipment for cash proceeds but there is no opportunity to capture the value associated with the **goodwill** of the business **unless** key employee, Jack, is willing to purchase Don's stock.
- This is a circumstance in which Don, the majority owner, has a strong incentive to enter a buy-sell agreement—to provide a market for his shares and to capture for his family some of the value associated with the good will of Plumbing Perfection.

BUY–SELL AGREEMENTS—TERMS

Fixed Price

Upon entering a buy-sell agreement, the parties may set a fixed price to govern the transaction if there is a death of a shareholder.

EXAMPLE 4–7:

- Consider the ABC Company again in which Chris, Terry, and Sean each own a 33¹/₃% interest in the Company.
  - Each owns 100 shares of the company.
- There may be a redemption agreement which may provide that upon the death of a shareholder, the company shall be obligated to buy and the decedent's estate shall be obligated to sell the 100 shares of stock of the decedent.
- The purchase price is set at $3,250 per share by mutual agreement of Chris, Terry, and Sean at the signing of the buy-sell agreement.

If an owner of the closely held business dies shortly after the signing of the buy-sell agreement with a fixed price, there is the advantage that the price reflects a value recently determined and mutually agreed to. Nevertheless, there are at least two dangers with respect to a fixed price agreement:

1. The parties do not take the time to reconsider and to re-set the price on a periodic basis.
   - The original buy-sell agreement was signed in 1996 and the buy-out price was fixed at $3,250 per share. The price has never been updated. Sean dies in 2003. The previously fixed price of $3,250 per share no longer reflects the real value of the company.
2. Even if the owners religiously reconsider the fixed price each year, they may have different perspectives and incentives at the meeting to set the price.

EXAMPLE 4–8:

- Assume that Sean is diagnosed with a very serious and possibly life-threatening disease.
- At the annual meeting to re-set the fixed price, Sean may focus on the growing market, the success of the cost-cutting program, and the promise of emerging employees.
  - Sean may believe in good faith that a relatively high price is the true measure of value.
- Chris and Terry by contrast, facing the loss of Sean's management abilities, may focus on growing competitive pressures, the tightness of the labor market, and other negative factors.
  - Chris and Terry may believe in good faith that a relatively low price is the true measure of value.
- That is, as circumstances change, it may not be possible to arrive at a mutually agreeable fixed price.

FORMULA PRICE

Alternatively, the parties may agree that the price to be paid upon the death of an owner (or other triggering event) will be determined according to a formula computed at the time of death. The formula may include one or more of the following factors:

- Book value of company assets.
- Appraised value of company assets.
- Gross revenues.
- Gross revenues averaged over a period of more than one year.
- Gross revenues averaged over a period of more than one year **times** a multiple (For example, the value of the company shall be equal to the gross revenues averaged over the prior three fiscal years times .8. If average annual gross revenues equals $2,000,000, the value of the company shall be $1,600,000.)
- Net revenues (note that net revenues may be computed net of all expenses except shareholder compensation, or alternatively net of all expenses including shareholder compensation).
- Net revenues averaged over a period of more than one year.
- Net revenues averaged over a period of more than one year **times** a multiple. (This is, in effect, a capitalized earnings approach.)
- Cash on hand.
- Accounts receivable at the date of death (perhaps discounted to reflect collections).
- Life insurance proceeds.
- Accounts payable.
- Short-term and long-term debt.

EXAMPLE 4–9:

The purchase price shall equal:

- Book value of company assets, plus
- Cash on hand, plus
- Accounts receivable, minus
- Accounts payable and debt.

EXAMPLE 4–10:

The value of the company shall equal:

- Appraised value of company assets, plus
- Net revenues averaged over the prior three years times 1.5.
  - For this purpose, net revenues shall be computed net of all expenses except the compensation of employees who are also owners.

APPRAISAL

The buy-sell agreement may provide that the value of the interests in the closely held business will be determined by the mutual agreement of the parties, or if there is no such agreement, then the value shall be determined by appraisal.

In this regard, various approaches are used. Some buy-sell agreements provide that the value shall be determined by an appraiser who is selected by an unanimous agreement of the parties. Other buy-sell agreements provide that each party will select an appraiser and the appraisals of those professionals will be averaged. Other buy-sell agreements provide that each party will pick an appraiser and that those appraisers will unanimously select an independent appraiser and that independent appraisal shall govern for purposes of the determination of price.

Note that in structuring a buy-sell agreement which uses the appraisal method, it is important that the buy-sell agreement specify whether or not the value of a minority interest will be **discounted** and/or whether the value of a majority interest will receive a **premium**. Chapter 1 noted that there is often a **discount** associated with a minority interest and that indeed the IRS recognizes this reality for purposes of the federal estate tax and the federal gift tax.

EXAMPLE 4–11:

- Assume Chris, Terry, and Sean enter a buy-sell agreement which provides that upon the death of a party an appraiser picked by unanimous agreement of the parties will determine the value of the company.
- Assume Sean dies and that the appraiser determines that the ABC Company has a value of $1,200,000.

(continued)

EXAMPLE 4–11 (continued)**:**

- Is Sean's interest worth $400,000, or should Sean's interest be discounted by 25% to $300,000 because it is a minority interest?
- This issue should be expressly addressed in the buy-sell agreement, particularly in one which relies on the determination of price by appraisal.

FUNDING

Life Insurance

We observed previously that there are several ways to fund the purchase of an interest upon the death of a shareholder. In a cross-purchase agreement, the other owners may have sufficient personal funds to make possible a purchase. One of the common methods to fund the purchase of stock is insurance.

EXAMPLE 4–12:

- If there were a redemption-type agreement for the ABC Company, the company might purchase three life insurance policies, one each on the life of Chris, Terry, and Sean.
  - If Sean died, the company would use the proceeds from the life insurance policy on Sean's life to fund the purchase of Sean's shares.
- The payment of life insurance proceeds to a C corporation may subject those proceeds to alternative minimum tax—there may be an income tax burden on the receipt of the life insurance proceeds.
- A C corporation, other than a "small corporation" (less than $5,000,000 in gross receipts) may be subject to the AMT.
  - The AMT does not apply to an S corporation.
- The alternative minimum tax is a flat 20% tax; a corporation is subject to the AMT if the AMT exceeds the regular tax.
- The alternative minimum taxable income (AMTI) is increased by 75% of the excess of the adjusted current earnings of the corporation over the pre-adjustment AMTI. For these purposes the proceeds of life insurance, in excess of the corporation's basis, are included in the ACE adjustment.

Future Earnings

In many instances, the buy-sell agreement may effectively provide that part of the purchase price will come from the **future earnings** of the business.

EXAMPLE 4–13:

- Consider the circumstance of Don and Jack in Plumbing Perfection.
- If Don dies, Jack may not have the personal resources to purchase Don's interest in the business.
- There are at least three possibilities:

1. Jack may purchase a life insurance policy on Don's life—to provide the funds for the purchase of Don's stock.
    - Note the anomalous circumstance that often a person in Don's situation will consider having Plumbing Perfection purchase a $300,000 policy on Don's life to fund the redemption.
2. Alternatively, Don may consider providing bonus compensation to Jack—to enable Jack to purchase a $300,000 policy on Don's life to fund a cross-purchase acquisition.

In either circumstance, Don is effectively using "his own money" to purchase the policy and hence to purchase the business.

- Don would be better served simply to purchase a $300,000 policy on his own life, with no buy-sell agreement.
- That is, if the company is purchasing the policy or if the company is providing bonus compensation to Jack to purchase the policy, neither Jack nor the future earnings of the company (after Don's death) will play any role in providing value of the purchase.
- In effect, it is Don's own money which eventually provides the funds for the purchase of his own interests.

3. Alternatively in the Plumbing Perfection situation, the buy-sell agreement may provide that upon Don's death, Jack will purchase the business for a cash down payment and a promissory note.
    - The contemplation is that Jack will be able to operate the business in the future at a profit.

(continued)

EXAMPLE 4–13 (continued)**:**

- Part of the future profits (earned after Don's death) will be used to purchase Don's shares.
- In this circumstance it is not just "Don's money" which is providing the value for the purchase.

Promissory Note

In any buy-sell agreements which include a promissory note careful attention must be given to the following:

- **The term**

  Generally a shorter term note (one to six years) is better than a longer term note, given the uncertainties which attach to the future of a closely held business.
- The note generally should be secured, not only by the earnings and assets of the company, but also by the personal assets of the new owner.
- **Interest rate**

  It may be appropriate to vary the interest rate to reflect changes in market conditions.

INTRA–FAMILY BUY–SELL AGREEMENT

There may be circumstances in which it is appropriate to prepare a buy-sell agreement to govern intra-family transactions.

EXAMPLE 4–14:

- Consider Marvelous Masonry.
- In the current circumstance, the business of Marvelous Masonry has a value of $2,500,000 and Mike and Mildred's other assets have a value of approximately $1,000,000.
- If there are no life insurance proceeds or other assets to provide equalization, there will be approximately $1,000,000 of federal estate tax and the $2,500,000 business will pass in equal shares to Tim, Ann, and Barbara.
  - Tim is the son who actively runs the business.

(continued)

EXAMPLE 4–14 (continued)**:**

- Ann and Barbara have no active participation.

■ After the death of Mike and Mildred, this arrangement may have at least one of two negative results:

1. Tim earns a salary and receives benefits from the business.
   - The business pays no dividends.
   - Neither Ann nor Barbara has a "spendable inheritance."
2. Alternatively, Tim is a spectacular success, taking risks, working hard, and dramatically increasing the value of the business.
   - Ann and Barbara see the value of their stock (eventually to be realized) increasing without any risk or effort on their part.

■ In this circumstance, if the Marvelous Masonry business passes in one-third interests to each of the three children, Mike and Mildred must make a decision as to who will have voting control.

■ One possibility is to recapitalize the company so that Tim's stock is voting stock and the stock of Ann and Barbara is nonvoting stock.

■ If no such change is made, then the majority owners (Ann and Barbara) can dictate the operation of the business.

■ Given the possible conflict, it may be advisable to use a redemption-type buy-sell agreement in which Marvelous Masonry agrees to purchase the stock of Ann and Barbara after the death of Mike and Mildred.

- The goal is to move toward a situation in which Tim owns 100% of the company.

■ In proceeding with a buy-sell agreement, the family must consider the following:

- How should the stock price be determined?
  - ▪ Given the conflicting interests and the possible damage to family relationships, it may be advisable to set the price by independent appraisal.
- What will be the source of funds for the purchase?
  - ▪ Can life insurance be used for this purpose?
  - ▪ If there is no life insurance or limited life insurance, what does a realistic assessment suggest with respect to the "extra cash" which Marvelous Masonry may generate over time in order to make possible the purchase of Ann's stock and Barbara's stock?

(continued)

EXAMPLE 4–14 (continued)**:**

- Assuming that the purchase must take place over time, what should be the terms of the promissory note to Ann and Barbara. (Note that such a promissory note often results in a difficult family circumstance.)
- After the death of Mike and Mildred, the Marvelous Masonry business begins to falter.
- Tim does not have sufficient working capital to continue.
- Tim requests that his sisters permit him to omit payment under the promissory note for several months.
- At what point do the sisters foreclose on their brother? Difficult question.

Sometimes the closely held business may have real property or divisions which may be allocated to certain family members as part of the buy-sell agreement.

EXAMPLE 4–15:

- If Marvelous Masonry held substantial real estate, that real estate might pass to Ann and Barbara as a part of the buy-sell agreement (with the business property to be leased by Tim presumably at a net fair market value lease).
- The ownership of real estate and the associated lease income may provide at least a partial "spendable inheritance" to Ann and Barbara.
- Similarly it may be that a business owned several divisions, one of which may be sold to provide cash proceeds to the family members (e.g., Ann and Barbara) who are not participating in the continuation in the closely held business.

It may be necessary to structure a buy-sell agreement even if the estate plan contemplates the continuation of the closely held business by family members. If there are non-participating family members (e.g., Ann and Barbara), it is important to make sure that their interests are protected. In part, this reflects the natural family wish that each child be treated equally.

Estate Tax Value

A buy-sell agreement may be useful in fixing the value of the interest (of a deceased owner) for estate tax purposes. Section 2703 may cause the IRS to disregard a buy-sell agreement in determining the estate tax value of interest in a family business. Generally the regulations provide that a buy-sell agreement for a family-owned business must meet three requirements in order to be respected for valuation purposes:

1. The agreement is a bona fide business agreement.
2. The agreement is not a device to transfer property to the natural objects of the transferor's bounty for less than full and adequate consideration in money and money's worth.
3. At the time the agreement is created, the terms of the agreement are comparable to similar transactions entered into by business in an arm's-length transaction.

Particularly in a closely held family business, the buy-sell agreement "will be carefully scrutinized to see if it is a 'testamentary device.'" (*Estate of Joseph H. Lauder v. Commissioner*, T.C. Memo 1994).

TRIGGERING EVENTS

Most commonly, a buy-sell agreement governs a purchase-sale of interests if one of the owners of the closely held business dies. A purchase-sale may also be triggered by other events.

Disability

The buy-sell agreement may provide that upon the permanent disability of an owner, the disabled owner will sell the interest in the closely held business to the other owners. Disability, as a triggering event, may be part of a redemption-type agreement or a cross-purchase-type agreement. The same issues with respect to the determination of price arise in the context of disability as in the context of a death. The company (or the other owners) may provide funding through disability insurance.

Retirement

Although it is unusual, a buy-sell agreement may provide for the purchase of the interest of an owner if the owner retires. Again the determination of price is a key issue. In the retirement context, there may not be insurance proceeds (disability insurance or life insurance) available to fund the purchase of the retiring owner's interest in the business.

Chapter 5

Gift Planning

GIFT STRATEGIES—INTRODUCTION

For the owner of a valuable closely held business, traditional testamentary planning techniques may not be sufficient to effect an eventual transfer of the business (and the associated value) to the family free of federal estate tax. For a married couple, planning which captures both husband and wife's applicable credit amount can reduce the federal estate tax. Life insurance held in an irrevocable life insurance may pass free of federal estate tax to the second generation. This planning, however, may not be sufficient to eliminate the federal estate tax. For the examples of Marvelous Masonry and Spectacular Sod, there will be substantial federal estate on the second estate. For such families owning a closely held business, a program of lifetime gifts may be a central element in transferring the family wealth with a minimum of transfer tax liability.

GIFTS—ANNUAL EXCLUSION GIFTS

ANNUAL EXCLUSION AND QUALIFIED TRANSFER EXCLUSIONS

An individual may transfer up to $10,000 of present interest gifts to each donee in each calendar year without incurring a gift tax. The $10,000 amount is subject to be increased by a cost-of-living adjustment and rounded to a multiple of $1,000 under the provisions of the Taxpayer Relief Act of 1997. Few states have a state gift tax.

Also excluded from the transfer of property as a taxable gift is a "qualified transfer." A qualified transfer is an amount paid on behalf of an individual as:

- Tuition to an educational organization for the education or training of such individual, or
- To any person who provides medical care to such individual.

These transfers **must** be made directly to the educational organization or to the person who provides medical care and not indirectly or in trust (IRC §2503).

CUMULATIVE EFFECT

EXAMPLE 5–1:

- Consider the estate tax situation of Jim and Jane with Spectacular Sod.
- With an estate of more than $5,000,000, they face the prospect of very substantial federal estate tax even if the two of them survive until 2006.
- To reduce the federal estate tax, Jim and Jane may proceed with a program of $10,000 annual exclusion gifts to family members.
- They might proceed as follows:
  - $20,000 a year gifts to each of their two sons.
    - Over a period of ten years, this would constitute a transfer of $400,000 in value (plus the income and appreciation attributable to such stock interest during the ten-year period).
    - Assuming an eventual federal estate tax rate of 55%, this would constitute an eventual federal estate tax saving of at least $220,000.
- Or they might proceed as follows:
  - $20,000 a year gifts to each of the sons, to each of the daughters-in-law, and to each of the three grandchildren.
    - Over a period of ten years, this would constitute a transfer of $1,400,000 in value (plus the income and appreciation attributable to such stock interest during the ten-year period).
    - This would constitute an eventual federal estate tax saving of at least $770,000.
- In addition to the above programs, they could also make gifts each year of all tuition expenses and all medical expenses for the family.

SEVERAL OBSERVATIONS

Several observations are pertinent:

- A program of annual exclusion gifts can very effectively reduce the taxable estate of the parents and save significant estate tax.
- Parents are well-advised to commence a program of annual exclusion gifts only if the program will not jeopardize the long-term financial independence and well-being of the parents.

EXAMPLE 5–2:

- Mike and Mary are not ideal candidates to commence a program of gifts.
  - They are only 56 years old.
- More than 80% of their wealth is in the business and their residence; they do not have a substantial investment fund to provide for their long-term health and well being.
- Jim and Jane of Spectacular Sod, with a family wealth of more than $5,000,000, are better situated to begin a program of systematic annual exclusion gifts.

- Obviously, it is not required that the full $10,000 a year be given.
  - Many clients start a gift program on a go-slow pace, giving only to the children (and not to the grandchildren or in-laws).
  - Similarly, many clients start with gifts of less than $10,000 a year.

Issues related to the timing of gifts, the equalization of gifts among the branches of the family tree, and property well-suited for gifts are discussed later in this chapter.

GIFTS TO MINORS

For Jim and Jane of Spectacular Sod, a program of annual exclusion gifts may include gifts to minor grandchildren. Because a minor, by definition, does not have the legal capacity to own property, the most common vessel for a gift to a minor is a custodial account or trust.

UTMA

Most states create a custodial account under the Uniform Gifts to Minors Act (UGMA). In fact, many states have now generalized the custodial statute so that a custodial account can hold not only property received by gift but also property received by testamentary transfer (will). Many states now call this statute the Uniform Transfers to Minors Act (UTMA).

An UTMA account is a custodial account in which the custodian holds property on behalf of a minor. The UTMA statutes typically provide that the income and principal held in the custodial account may be used for "the benefit of" the minor. In most states the custodial account does not vest in the individual at the age of majority (age 18 in most states) but rather at age 21. The establishment of a UTMA account to hold annual exclusion gifts to a minor is a simple economical procedure. Virtually all banks, mutual fund companies, and financial institutions permit the establishment of a UTMA (or a UGMA) account.

From a federal gift tax perspective, the key is that a gift to a UTMA account qualifies as a "present interest" and therefore qualifies for the $10,000 annual exclusion.

SECTION 2503(C) TRUST

As an alternative method to make a present interest gift, clients may establish a §2503(c) trust. It provides that a gift to a trust for an individual who is not yet 21 years of age shall nevertheless be considered a present interest gift and qualify for the $10,000 annual exclusion if the trust has the following attributes:

1. The property and the income therefrom may be expended by, or for the benefit of, the individual before attaining the age of 21 years.
2. To the extent the principal and income is not so expended, it will pass to the individual upon becoming 21 years of age (or in the event the individual dies before attaining 21 years of age, to be payable to estate).

CRUMMEY TRUST

Purpose

Though a UTMA account or a §2503(c) or §2503(b) trust is a simple and economical approach, there is the disadvantage that the child has the legal right to receive all of the property outright at age 21. This may not be the intent of the donor. Historically, then, practitioners searched for a method of transferring property to a trust for a child or grandchild which would have the following two attributes:

1. Gift would constitute the transfer of a "present interest" and so would qualify for the $10,000 annual exclusion.
2. Child would not have the right to withdraw/spend the property at age 21.

Limited Withdrawal Right

To meet this goal, planners now establish an irrevocable gift trust which provides that the beneficiary (child/grandchild) has the right to withdraw the gift for a 30-day period after the gift is made to the trust. The child, or the parent acting on behalf of the minor child, has the legal right to make the withdrawal. The right is for a limited period; if the child does not exercise the right of withdrawal within 30 days, then the right lapses.

The right is generally non-cumulative; if the child decides to exercise the right of withdrawal in year two, the child can withdraw only the property given to the trust in year two (and not the property given to the trust in year one).

This technique—granting the beneficiary the right to withdraw the value of the gift for a limited period of time in order to qualify for the $10,000 annual exclusion—was first litigated in the case of *Crummey v. Commissioner*. The Crummey Court approved the technique.

Sample Provisions

EXAMPLE 5–3:

- Jim and Jane may establish a trust for their 10-year-old grandchild with the following provisions:
  - Independent trustee (or perhaps Will as trustee) shall distribute income and principal for the health, support, maintenance, and education of the grandchild and the grandchild's future-born children.
  - Each year the grandchild shall have a right for 30 days after the gift to the trust to withdraw from trust principal the lesser of:
    - Value of the gift.
    - $10,000 (or $20,000 if there is gift-splitting).
  - The trust shall continue until the grandchild attains 35 years of age or dies. Upon termination at age 35, the remaining principal shall be distributed outright to the grandchild.

Vesting

Crummey Trusts can be a useful way to postpone the age of vesting of property transferred in trust to a child or grandchild by gift. As previously noted, a UTMA custodial account generally terminates when the child reaches 21 years of age. At that time the child has the absolute legal right to receive the property.

Similarly, a §2503(c) trust terminates when the child reaches 21 years of age. It is possible to provide that the child has a 30-day period beginning at age 21 to withdraw the property from a §2503(c) trust and that if no such withdrawal is made the property will continue in trust for an extended period.

However, a child at a troubled time in life, or dealing with problems of substance abuse, or under the influence of a scoundrel may choose to exercise the right of withdrawal. This legal fact — that the child has the legal right to withdraw the money from an UTMA custodial account or a §2503(c) trust at age 21 — must be considered in light of the appreciation of the property.

EXAMPLE 5–4:

- If Jim and Jane establish a trust for a grandchild when the grandchild is three years old and contribute $20,000 a year, with 5% appreciation, the property will be worth well in excess of $550,000 when a child became 21 years of age.
- The transfer of $550,000 outright to a child at age 21 may not be a constructive force promoting the child's hard work, education, and self-fulfillment.
- Therefore, using a Crummey Trust (with rights of withdrawal) may be an important planning vehicle.

To reiterate, the Crummey Trust can be structured so that the gifts constitute "present interest gifts" for purposes of the annual exclusion but the vesting of the property can be postponed until a child attains a designated age of maturity (or the vesting can be postponed until the child dies—the Crummey Trust may last for the entire lifetime of the donee-child).

RETAINED INTEREST

Section 2036 provides that the "value of the gross estate shall include the value of all property, to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, but has retained for his life or the possession or enjoyment of, or the right to the income from, the property."

EXAMPLE 5–5:

- Donor makes a gift to his child, outright or in trust, with the legal provision that the donor will have the right to use the income or principal in the event of a health emergency.
- The value of the property would be included in the gross estate of the donor because the donor has retained the enjoyment of, or the right to the income from, the property.

RETAINED CONTROL

Section 2036 also provides that the value of the gross estate shall include the value of any interest of which the decedent has made a transfer, but has retained "the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or income therefrom."

Therefore, the general rule is that the transferor-donor should not serve as custodian of an UTMA account or any gift trust for a child or grandchild.

EXAMPLE 5–6:

- Parent established a Crummey trust for his child with the provision that the parent shall serve as trustee until the child attains 35 years of age.
- If the parent dies, the value of the trust principal will be included in the gross estate of the parent—because the parent retained the right to govern the timing and/or allocation of distributions of income and principal.

PLANNING CONSIDERATIONS

THREE–YEAR RULE

In the past, §2035 provided that if a person made a $10,000 annual exclusion gift and died within three years of the gift, the donated property would be “pulled back” into the gross estate of the donor. That is no longer the case. While there are certain exceptions (such as a transfer of a life insurance policy) the basic rule under §2035 is that an annual exclusion gift made during the three-year period ending on the date of the decedent’s death is not part of the decedent’s gross estate.

EXAMPLE 5–7:

- If a donor with a substantial net worth makes a $10,000 annual exclusion gift on Monday and dies on Tuesday, the $10,000 amount is not part of the taxable estate.
- The resulting federal estate tax savings will be in the range of $3,700 to $5,500 (depending upon the applicable federal estate tax bracket).

EXAMPLE 5–8:

- Consider Grandpa Jones.
- He is 84 years old, has three children and six grandchildren.

(continued)

EXAMPLE 5–8 (continued)**:**

- Grandpa Jones has a terminal illness, diagnosed just before Thanksgiving, and he has an apparent life expectancy of only two to six months.
    - He is single.
- One recommended planning strategy for Grandpa Jones would be to make $90,000 of annual exclusion gifts to the family members immediately and $90,000 in additional gifts on January 1 of the next year.
- By making these gifts, Grandpa Jones would shift $180,000 out of his taxable estate. Even if Grandpa Jones died later in January, federal estate tax saving would result, possibly as high as $85,000 (depending on the applicable federal estate tax bracket).
- Note that this strategy also applies with respect to "qualified transfers."
- Grandpa Jones may pay the tuition of any child or grandchild attending private school, perhaps prepaying the tuition at least through the end of the current academic year.
- Grandpa Jones may also pay any medical expenses directly to the provider; these gifts will not be part of Grandpa Jones's gross estate for federal estate tax purposes.

TIMING OF ANNUAL EXCLUSION GIFTS

Obviously, as noted above, it is advantageous to make $10,000 annual exclusion gifts early in the calendar year. If an individual postpones annual exclusion gifts until December and dies mid-year, the family has lost the associated federal estate tax saving.

EQUALIZING STRATEGY—LIFETIME GIFTS

Often, parents wish to proceed with two seemingly conflicting estate planning goals:

- To maximize use of the $10,000 annual exclusion.
- To treat equally the branches of the family tree.

EXAMPLE 5–9:

- Let's look at Jim and Jane who have two children and three grandchildren. All three grandchildren are the children of son Will.

(continued)

EXAMPLE 5–9 (continued)**:**

- If Jim and Jane proceed with a program of $10,000 annual exclusion gifts to all descendants and in-laws, they will annually give $40,000 to the "older branch" of the family tree, and $100,000 to the younger branch.
- If they were to sustain such a program of gifts for ten years, the disparities would be very substantial:

Older Branch (Derrick)	$ 400,000
Younger Branch (Will)	$1,000,000

- To accomplish both goals, a family may consider combining $10,000 annual exclusion gifts and unified credit gifts.
- In this example, each year Jim and Jane may proceed as follows.
  - They may give $20,000 to Will, $20,000 to Will's wife, and $20,000 to each of the grandchildren, all annual exclusion gifts.
    - This will represent $100,000 of gifts to Will's branch of the family tree.
  - They may then give a $20,000 annual exclusion gift to Derrick, a $20,000 annual exclusion gift to Derrick's wife, **and** a $60,000 unified credit gift to Derrick.
    - The strategy will have the advantage of maximizing the use of the annual exclusion **and** treat equally the two branches of the family tree.

EQUALIZING STRATEGY—CATCH–UP PROVISION IN WILL

There is an alternative strategy. If Jim and Jane are not able to make lifetime gifts in this equalizing mode, the survivor of Jim and Jane may include an equalizing provision—a "catch-up" provision—in his will. That provision may be of the following sort:

> *During my lifetime I anticipate that my spouse and I will make annual exclusion gifts to our children, grandchildren, and in-laws. I shall keep a written record of such gifts or I may have my accountant keep a written record of such gifts. My personal representative (executor) may rely on such written records for the purposes of this Article. The personal representative shall compute the total value of lifetime gifts made after 1995 (other than holiday gifts and birthday gifts) by my spouse or me to the family of each of my children. For this purpose the child's family shall include the child, the child's descendants, and the child's spouse. The personal representative shall compute the total amount of property given to each family. The highest total amount to a family shall be called the Target Amount. The personal representative shall make a distribution to any child whose family*

> *received an amount less than the Target Amount equal to the difference between the Target Amount and the amount of total gifts received by that child's family. If such child is not living, the distribution of that difference shall be to the child's descendants, by representation. The balance of my estate shall be distributed in equal shares to my children.*

This is obviously a simply drawn provision, but the idea is often used—the provision in the will to effect equalization among the branches of the family tree for a program of lifetime gifts. Notably there may be significant timing differences with respect to gifts to children during lifetime and a "catch-up provision" in the will. The child who receives property by lifetime gift may earn interest on such property and may gain the benefit of appreciation. Therefore, clients sometimes consider one of two alternative strategies:

1. Provide that the property given to a child during lifetime is valued at the parent's death—to provide the valuation for the catch-up gift.
   - This is possible if the gift is of an interest in a family business or other property retained by the donee-child.
   - It is more difficult if there may be sale by the child or commingling of the gift, resulting in a problem of "tracing" the gift.
2. Provide that there will be an imputed interest rate with respect to lifetime gifts, so that the child receiving the "catch-up gift" will receive not only the principal amount of the gift but also a designated interest rate from the date of gift until the date of the parent's death.

These two approaches to equalization should be given careful consideration. A program of annual exclusion gifts can be a very effective way to reduce the federal estate tax for a wealthy family. A program of equalization can help to maintain family harmony.

Power of Attorney

As noted, if a person makes a $10,000 annual exclusion gift on Monday and dies on Tuesday, the $10,000 amount is not part of the decedent's taxable estate. Such a gift may be made by the individual or by an agent acting under a durable financial power of attorney.

From a practical standpoint, the power of attorney:

1. May provide guidelines or limitations with respect to the making of such gifts.
2. May, if the power of attorney so limits, permit gifts only of the $10,000 annual exclusion amount (plus direct payments of tuition and medical care).

From a legal perspective, the IRS has argued that gifts made by an agent under a durable financial power of attorney are effective for federal gift tax purposes only if the agent is expressly authorized to make gifts. The IRS has taken the position (and successfully in some cases) that it is not sufficient if the power of attorney is simply a broad general authorization.

Consider a power of attorney with the following authorization:

> *I authorize my agent to take any step or act of any kind, whatsoever, including any act which I could legally do in my own person.*

The IRS takes the position that such a broad authorization is not adequate for purposes of the federal gift tax. Stated differently, a durable financial power of attorney must expressly authorize the agent to make gifts if such gifts are to be removed from the principal's (donor's) taxable estate. This is an issue which is often overlooked by estate planning attorneys.

NON–TAX CONSIDERATION

Timing

Understandably, parents (or a single individual) are reluctant to commence a program of systematic $10,000 annual exclusion gifts to children and grandchildren if the gifts may jeopardize their long-term financial independence and well-being. The decision whether to proceed with a program of $10,000 annual exclusion gifts, then, is often a function of the donor's age, financial situation, health, and level of risk aversion. For many planners, the general rule is to recommend a program of $10,000 annual exclusion gifts if the client is "very rich or very old." Regardless of how rich or how old, if the donor does not want to make a gift or embark on a gifting program, then the potential tax savings will not make it "right" and the donor should not make the gift.

Personal Impact

It is also important to consider the emotional-incentive-family effect on the recipient. Will a program of $10,000 annual exclusion gifts to a daughter hurt the masculine pride of the son-in-law? Will a program of $10,000 annual exclusion gifts reduce the incentive or work ethic of the child or grandchild? Will the child begin to expect the annual gifts; will the child look on the $10,000 annual exclusion gifts as an entitlement?

Parents may decide for personal reasons that the gifts should not be made on a predictable basis. Parents may also decide to include as part of the gifts certain transfers which make possible enjoyment for the family (and not pure financial transactions).

EXAMPLE 5–10:

- One wealthy couple in their early sixties had two children (both married) and no grandchildren.

(continued)

EXAMPLE 5–10 (continued)**:**

- Over five years, the parents went forward with the following gifts:

Year 1 $20,000 to each of the four individuals, including in-laws ($40,000 per family).

Year 2 All-expense-paid trip to Hawaii for all three families (including the parents). No other gifts.

Year 3 A pretty sweater to each of the four individuals over the holidays. No other gifts.

Year 4 $5,000 to each of the two children (but no transfer to an in-law). No other gifts.

Year 5 A new automobile for each of the two couples.

- Though such a program of gifts does not maximize the benefit of the $10,000 annual exclusion, it is unpredictable (the children do not know what to expect) and it may have elements of family enjoyment.

VOTING CONTROL

For the owner of a closely-held enterprise, voting control is a key business factor. The owner may not want to proceed with gifts which reduce the owner's voting interest to less than 51%. Note in this regard:

- It may be possible to recapitalize the company (a corporate recapitalization or a restructuring of a partnership or LLC) so that the entity has voting interests and non-voting interests.
  - In this manner, it may be possible for the senior generation to reduce its equity ownership to substantially less than 50% while maintaining voting control.
- The owner of the closely held business may want to maintain voting control for understandable practical reasons but the sacrifice of voting control can be a **plus** in the estate planning domain.
  - If the owner of a closely held business dies and does not have voting control, the value of the owner's business interest for federal estate tax purposes may be significantly discounted.

In this regard, the owner may intentionally make transfers to a spouse.

EXAMPLE 5–11:

- Assume that Mike transfers 10% of the ownership interest in Marvelous Masonry to Tim, that Mike gives a 45% interest to Mildred, and that Mike retains a 45% interest.
- If either Mike or Mildred dies, the 45% interest will likely be allocated to the Credit Shelter Trust and the Marital Trust.
- Upon the death of the survivor, the survivor's estate will hold a 45% interest and will generally be entitled to a significant discount.
- Note that recent legal authority does not require "attribution" of the interests held in the Credit Shelter Trust and the Marital Trust established as part of the first parent's estate plan.
- That is, even though Mildred, as survivor, may be the trustee of the Credit Shelter Trust and the Marital Trust and accordingly may effectively control 90% of the stock, the Trusts' 45% interest is not added to Mildred's 45% interest in determining the value of Mildred's gross estate for federal estate tax purposes.
- This ownership structure, then, may have important implications in the gift arena and also important implications in the more general estate planning arena.

NON–SPENDABLE GIFT

Parents are often concerned that annual exclusion gifts of cash to children, even adult children, may have an adverse impact in terms of the child's incentive to go forward with education and/or work. In this regard, even for a family which does not own a closely held business, the gifts of interests in a family vacation home may be ideal—the annual exclusion gifts shift value to the second generation but do not put the "spendable funds" into the hands of the children and grandchildren. For the owner of a closely held business, gifts of minority interests in the business may similarly accomplish a tax-free shift in wealth to the second generation without putting "spendable funds" in the hands of the children. One commentator has termed these "annual illusion gifts."

CAUTION

In proceeding with gifts of interests in a closely held business, the planner must be careful not to disqualify the business interest for favorable tax treatment under provisions of the Internal Revenue Code. Recall that qualification for favorable tax treatment in the estate tax domain may hinge on the decedent's estate meeting a percentage test in terms of the closely held business.

- Special use valuation under §2032A requires, among other tests, that 50% or more of the adjusted value of the gross estate consist of the adjusted value of the real or personal property being used for a qualified use and that 25% or more of the adjusted value of the gross estate consist of the adjusted value of real property.

- Section 2057, providing a deduction from the value of the gross estate of the adjusted value of a qualified family-owned business interest (QFOB) requires that the sum of the adjusted value of the QFOB interest plus the amount of the gifts of such interest exceed 50% of the adjusted gross estate.
- It may be useful for a family which is "close" for these purposes to make gifts of property **other than** QFOB interests, effectively raising the percentage ownership of QFOB interests above 50%.
- Section 6166 provides for an extension of time for the payment of federal estate tax. To qualify, the value of the interest in a closely held business must exceed 35% of the adjusted gross estate.

The planner, then, must proceed with caution in making gifts of interests in a closely held business not to inadvertently disqualify an estate for favorable treatment.

LARGER GIFTS—APPLICABLE CREDIT AMOUNT

Basic Idea

For couples with very large estates, and particularly for those with appreciating assets, a program of $20,000 annual exclusion gifts may be only a start in reducing the eventual federal estate tax. The applicable unified credit ($650,000 in 1999 and increasing to $1,000,000 in 2006) may be applied to transfers made during lifetime by gift or after death by will. For families with large estates, it may be useful to consider a large gift ($250,000 plus):

- To shift appreciating property to the second and third generations.
- To transfer property at a discounted value for federal gift tax purposes.

EXAMPLE 5–12:

- A 70-year-old couple owns an undeveloped tract of real estate with a value of $700,000.
    - Assume the couple has other assets of $5,000,000.
- If the couple holds the real estate for 14 years and it appreciates at the rate of 9% a year, the real estate will have a value of $2,800,000 when the couple reaches 84 years of age.
- If the couple dies then, the transfer of the property will consume both unified credits ($2 million) and still result in a taxable transfer of $800,000.

(continued)

EXAMPLE 5–12 (continued)**:**

- By contrast, if the couple makes a gift of the $700,000 property, the transfer will use only a total of $700,000 of applicable credit protection.
- A current gift of the $700,000 tract of real estate will effectively shift $2,100,000 of future appreciation and result in an eventual federal estate tax saving of $1 million.

For couples with very large estates, then, making a large gift—to **shift future appreciation** beyond the reach of the federal estate tax—can be effective planning.

GENERATION–SKIPPING ASPECTS

As previously noted in Chapter 2, it is often advisable to combine two powerful planning ideas:

1. Making a large gift—to shift an appreciating asset out of the (eventually taxable) estate of the parent.
2. Transferring property to a generation-skipping trust for a child, so that the property will eventually pass free of estate tax and generation-skipping tax to the third generation.

Let us re-examine an example combining capitalizing on these two planning ideas.

EXAMPLE 5–13:

- Couple with a large estate owns a farm on the outskirts of the city which is in the path of development.
- The real estate, which currently has a value of $700,000, may increase substantially in value in the future.
- The couple considers giving an undivided 50% interest ($350,000) to each of their two children —to shift the value and the future appreciation out of the parents' estates.
  - The couple gives a $350,000 interest in the farm property to their 38-year-old son outright.
    - The property is later developed into a shopping mall, the son's 50% undivided interest will be worth $3 million at his death.
  - The $3 million will presumably be included in the son's taxable estate, generating estate tax of approximately $1,500,000.

Establishing a Trust

The parents in the above example would be well-served to consider making the gifts (the $350,000 of farm property) to a generation-skipping trust for the child. For example, the parents may establish a trust for the son which provides as follows:

> *The trustee shall distribute income and principal to our son and the son's descendants as the trustee may deem necessary or advisable to provide for the health, support, maintenance and education of a beneficiary. The trust shall terminate upon the death of our son. Upon our son's death, he shall have a special power of appointment exercisable among our descendants. If our son does not exercise such special power of appointment, the trust estate remaining upon termination shall be distributed to his descendants, by representation. Our son shall be the sole trustee.*

The parents could establish a trust of this sort and could make the $400,000 gift to the trust taking two tax steps:

1. Shield the transfer from federal gift tax by applying the unified credit.
2. Allocating $350,000 of the $1 million GST exemption (so that the trust would be "exempt" with an inclusion ratio of zero).

Significant Tax Savings

With this planning approach, the tax efficiency of the gift program would be greatly increased. Not only would there be significant tax savings on the transfer from generation one to generation two (from parents to son), there would also upon the eventual transfer from generation two to generation three (from the son to the son's children—the grandchildren).

For most sophisticated estate planners considering a program of large gifts for a client, the starting presumption is that the transfer to the child (or children) will be made in trust(s) exempt for generation-skipping transfer purposes. This can be very powerful planning. Some commentators assert that a large outright gift to a child is 50% good planning and 50% mistake. The outright gift of appreciating property to the child represents good planning between generation one and generation two but a mistake with respect to the eventual transfer of the appreciated property from generation two to generation three.

INCOME TAX CONSIDERATIONS

Basis Considerations

With respect to property transferred by way of gift, the basis of the property in the hands of the donee is the same as the basis of the property in the hands of the donor. That is, the donee takes a "carryover basis."

By contrast, when a person dies the property which is part of the decedent's taxable estate for federal estate tax purposes receives a new basis equal to the net fair market value at the date of death. Accordingly, the recipients of testamentary transfers acquire property with a "step-up" in basis.

This distinction—that property received by gift has a carryover basis but property received by testamentary transfer has a stepped-up basis—is critically important in structuring a gift program. Particularly for an older donor with highly appreciated property, the planner must give careful attention to the basis consequences of gifts. The gifts of property to children and grandchildren may remove the donated property from the donor's taxable estate, and save estate tax, but the gifts lose the opportunity to obtain a step-up in basis which would occur if the property were transferred by will. For older donors, it is often preferable to make gifts of cash or high-basis property.

EXAMPLE 5–14:

- Consider Grandfather with an estate of $2,500,000, including highly appreciated stock.
  - Assume that his wife is living but that she is in very poor health.
- Grandfather may give $1,200,000 of highly appreciated stock to Grandmother.
  - If she lives for 14 months and then dies, the stock will receive a step-up in basis in her estate.
  - The inherent capital gain will be eliminated. This can be an effective strategy **but** it works only if the recipient (the wife in this example) lives for at least one year after receipt of the gift.

Section 1014(e) provides that "if appreciated property was acquired by the decedent [the wife in this example] by gift during the one-year period ending on the date of the decedent's death and such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor), the basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent."

GIFT OR INHERITANCE—NOT INCOME

Though it is generally understood, it may be worthwhile to point out that neither a gift nor an inheritance is subject to income tax (except items constituting income in respect of a decedent such as funds in an IRA or qualified retirement plan passing to a non-spouse). The general rule of §102(a) is that "gross income does not include the value of property acquired by gift, bequest, devise, or inheritance."

Chapter 6

Sale and Ownership Considerations

SALE OF CLOSELY HELD BUSINESS

SALE TO FAMILY MEMBER

For some owners of a closely held business, one question is whether to **give** or to **sell** interests in the closely held business to children or other family members.

EXAMPLE 6–1:

- Consider Mike and Mildred, the owners of Marvelous Masonry.
- Their son, Tim, would like to take over the business.
  - Daughters Ann and Barbara do not participate in the business.
- In theory, there would be several advantages in Mike and Mildred beginning a program of annual sales of stock to Tim, perhaps selling Tim 5% of the Marvelous Masonry stock each year:

1. Mike and Mildred would receive the annual amount of $125,000, plus any interest on a promissory note. (The business is valued at $2,500,000.)
2. Mike and Mildred would begin to increase the percentage of their estate comprised of non-business assets.
   - This might make possible eventual transfers of a “spendable inheritance” to Ann and Barbara (instead of being required to distribute to Ann and Barbara as their inheritance a “non-spendable” stock inheritance).

DISCUSSION:

In practice, there are generally two major disadvantages associated with a sale of the closely held business by first generation members to members of the second generation:

1. The sale triggers taxable gain to Mike and Mildred and hence requires the payment of out-of-pocket capital gains tax.

(continued)

EXAMPLE 6–1 (continued):

- If Mike and Mildred transfer a 5% interest Marvelous Masonry to Tim by way of gift (using the annual exclusion and perhaps the unified credit), there is no out-of-pocket tax payment to the IRS.
- By contrast, a sale to Tim will likely trigger the "unnecessary payment of tax."

2. Generally, the second generation family member does not have the financial wherewithal to purchase interests in the family closely held business.
   - Tim is young, his compensation is moderate, he has not accumulated substantial independent assets.
   - Tim meets the typical profile of a second generation family member.
   - Even if Tim were to purchase a 5% interest in Marvelous Masonry with a small down payment and a promissory note, it would be a burden for Tim to make the payments on the promissory note.

Reducing the Burden

Assume the owners of a closely held business **do** decide to sell interests to a family member or a key employee, with the wish that the purchase will not be unduly burdensome for the purchaser.

EXAMPLE 6–2:

- Let's assume that Don and Patricia, as they near retirement, decide to sell Plumbing Perfection to key employee Jack.
  - Don and Patricia would like to recover significant value from the sale.
- However, to make the purchase less burdensome for Jack, Don and Patricia may take one or more of the following steps:

1. Discount the purchase price.
   - If the sale is made over a period of several years, Don and Patricia may each year be selling a minority interest in the company to Jack.
   - A minority interest may be discounted given its lack of marketability and lack of control.
   - This discount may be defended before the IRS as a legitimate "arm's length" transaction (and not a donative attempt to benefit a key employee or family member).

(continued)

EXAMPLE 6–2 (continued):

2. Adjust the purchase price based on future earnings.
   - If Plumbing Perfection earns significant net profits over the next five years, the purchase price may be adjusted upward.
   - If Plumbing Perfection earns lower net profits over the next five years, the purchase price may be adjusted downward.
3. Structure the promissory note with less burdensome provisions.
   - Longer term. Promissory note for 15 years, not five years.
   - Lower interest rate. The interest rate is set at the lowest possible A.F.R., not at competitive interest rate.
   - Non-payment. Provide in the promissory note that the holder may skip one monthly payment a year.

TYPICAL ALTERNATIVE STRUCTURE OF ESTATE PLAN

EXAMPLE 6–3:

- For Mike, Mildred, and Marvelous Masonry, or for Jane, Jim and Spectacular Sod, the continuity plan will have at least four key goals:
  1. Transfer the business to the second generation at a minimal tax cost.
  2. To the extent possible, provide for the equal treatment of the children in the transfers of the business and the associated estate plan.
  3. Maintain financial independence and security for the senior generation (Mike and Mildred, Jane and Jim).
  4. Maintain the financial strength and profitability of the closely held business.

EXAMPLE 6–4:

- For Marvelous Masonry and for Spectacular Sod, the strategy to meet these goals will usually not include a sale but would include several of the transfer techniques discussed in prior chapters:

(continued)

EXAMPLE 6–4 (continued):

1. Traditional planning with a credit shelter trust—to take advantage of the applicable credit amount of each parent.
2. $10,000 a year annual exclusion gifts.
   - For Mike and Mildred this may include gifts of company stock to Tim and possibly to Ann and Barbara.
   - For Jim and Jane, this may include $10,000 annual exclusion gifts to their two sons, Will and Derrick, and to Will's three children.
     - Jim and Jane's estate is substantially larger and they are older than Mike and Mildred.
     - They can afford $20,000 a year gifts to each family member without jeopardizing long-term financial security of Jim and Jane.
3. Ownership of life insurance in an irrevocable life insurance trust.
   - For Mike and Mildred, a significant policy may make possible the transfer of a tax-free "spendable inheritance" to Ann and Barbara.
   - For Jim and Jane the availability of tax-free insurance proceeds may make it possible for sons Will and Derrick to avoid the sale of family real estate holdings with promising development potential.
4. Larger Gifts.
   - Particularly for Jim and Jane with real estate holdings in excess of $5,000,000, it would be advisable to make larger gifts using the unified credit, shifting future appreciation to the second generation and the third generation.
5. Generation-Skipping Trusts.
   - For gift transfers and for testamentary transfers by Mike and Mildred or by Jim and Jane, it would be strongly advisable to make the transfers to a lifetime trust for a child.
   - Property held in trust may be protected from a divorcing spouse, from creditors, and, importantly, from federal transfer tax upon the eventual transfer to the third generation.
   - For Jim and Jane, transferring appreciating real estate to a generation-skipping trust for Will and Derrick (either by lifetime gift or by will) may make possible dramatic federal estate tax savings upon the eventual transfer to the third generation.

(continued)

EXAMPLE 6–4 (continued):

6. Buy-Sell Agreement.
   - If Mike and Mildred structure the estate plan so that shares in Marvelous Masonry pass to Ann and Barbara, the family may want to compose a buy-sell agreement to govern the future ownership, possibly with option rights in Tim to buy the stock of Ann and Barbara and possibly with "put" rights in Ann and Barbara to require Tim to purchase their shares.
7. Deferred Compensation.
   - It may be useful to establish a deferred compensation agreement for a senior owner/employee of the closely held business, as discussed below.

DEFERRED COMPENSATION

GENERAL STRUCTURE

It is often useful in estate planning for the owner of a closely held business to structure a non-qualified deferred compensation plan for a member of the senior generation.

EXAMPLE 6–5:

- Marvelous Masonry, for example, may structure a non-qualified deferred compensation arrangement for Mike.
  - A non-qualified deferred compensation plan is an arrangement in which an employer (Marvelous Masonry) promises to pay to an employee (Mike) in the future for services rendered currently.
- Typically the deferred compensation plan would make payments to the employee for a period of years after the employee's retirement or other termination of employment.
  - The term "non-qualified" refers to the fact that the plan does not attempt to meet the requirements under ERISA generally applicable to a qualified pension or profit-sharing plan.
- If Marvelous Masonry adopts a deferred compensation plan for Mike, Mike will have a source of retirement income.
- Although the deferred compensation payments will represent taxable income to Mike, there are tax advantages, however, associated with the deferred compensation plan:

(continued)

EXAMPLE 6–5 (continued):

1. The deferred compensation payments to Mike are deductible to Marvelous Masonry.
2. The existence of the deferred compensation plan may reduce the value of the company (since the earning stream of Marvelous Masonry is encumbered by its legal obligation to make deferred compensation payments to Mike).
   - This may make possible a further discount in value as a part of a gift program.

FORFEITURE SECURITY

In order to defer income tax, a deferred compensation agreement should contain a contingency such as a requirement that the employee must remain with the company a certain number of years after signing the agreement otherwise the employee would forfeit the rights to future payments. With such a forfeiture provision, there would be no "constructive receipt" of income under the agreement. Even if an employee's rights are not forfeitable, the employee will not be deemed to have constructive receipt of the income if the agreement is entered into before the employer earns the compensation in question and if the employer's promise to pay is not secured in any way. That is, there is no interest in a trust, escrow, or a specific asset.

The IRS has permitted the establishment of a so-called "Rabbi Trust" in conjunction with certain plans of deferred compensation. A Rabbi Trust enables an employer to transfer funds to an irrevocable grantor trust that satisfies certain criteria (including the requirement that the trust assets remain subject to the claims of the employer's general creditors). The Rabbi Trust does permit the set-aside of funds specifically identified for the eventual payment of deferred compensation.

LIFE INSURANCE

A deferred compensation plan is often integrated with a company plan of life insurance. In the earlier discussion of split-dollar agreements, it was noted that a split-dollar agreement is often coupled with a deferred compensation agreement. If the employee terminates employment, the split-dollar agreement is terminated and accordingly the employee must pay to the company the cumulative advances (premium payments) made by the company with respect to the policy. A deferred compensation agreement may provide for a lump-sum payment of deferred compensation to the employee upon termination of employment. In this planning, the funds available to the employee under the deferred compensation agreement, net of income tax, will be approximately equal to the payment due back to the company. The agreement will take into account the "grossing up" necessary to make the net payment equal to the amount "owed" to the employer upon retirement.

Under an alternative benefit plan for a closely held business, the company may purchase a permanent life insurance policy on the life of the employee. This may be for an owner-employee or a non-owner-employee. The company agreement may provide as follows:

- If the employee dies prior to the termination of employment, the company will pay a designated benefit to a beneficiary named by the employee. The benefit will be funded by the life insurance.
- If the employee retires, the company will pay deferred compensation to the employee. The deferred compensation will be funded by the value in the life insurance policy.

TAX EFFECTS

- Premiums on life insurance paid by the employer are not tax deductible.
- Benefits paid to employee by the company under the deferred compensation plan are deductible (assuming that the benefits constitute reasonable additional compensation).
- During employment, the employee is not taxed on the amount set aside by the employer to meet its financial obligation.
  - Of course, the employer does not deduct these amounts set aside, their deduction occurs when the employee receives the payments and picks up the income.
- Benefits received from deferred compensation plans by the employee (or his family) are taxable at ordinary income rates as received.
- In many circumstances, if the employee dies prior to retirement, the first $5,000 of benefits paid to the surviving spouse may be excluded from income as an employee death benefit.
- The commuted value of benefit payments would be included in the employee's gross estate for federal estate tax purposes.

To reiterate, a deferred compensation plan can be an effective way to provide retirement income to a key employee, whether the employee is an owner of the closely held business or a non-owner. In this latter regard, it can be an effective tool to retain the services of a key employee. Particularly if the deferred compensation is forfeited if the employee leaves prior to retirement (or prior to some specified period), the deferred compensation arrangement can play an important role in avoiding the loss of the services of a key management person.

EMPLOYEE STOCK OWNERSHIP PLAN

GENERAL

An employee stock ownership plan, commonly referred to as an ESOP, is technically considered a stock bonus plan. An ESOP is similar to a profit-sharing plan. Benefits may be distributable in the form of the employer's stock. An ESOP may be useful in the following circumstances:

- The owner of a closely held business would like to shift her investment, on a tax-deferred basis, into publicly traded securities.
  - This is accomplished by the taxpayer, but not a C corporation, selling securities such as stock in the closely held company to an ESOP and then buying "qualified replacement property" such as securities in another corporation, within a specific period of time.
- The owner of a closely held business would like to obtain an income tax deduction with little or no cash outlay.
  - Contribution of employer stock generates a deduction equal to its fair market value. A large deduction reduces cash flow out of a corporation in profit years and in loss years creates a carryback which might result in a tax refund for the corporation.
- An ESOP, in effect, develops a market for the stock.
  - In effect, the employer is creating a "future purchaser" to guarantee a market for sale. This can be done without causing a loss of corporate control by the owner of the closely held business.
- A corporation faces an accumulated earnings threat: An ESOP can be used to take cash out of a corporation.
- An owner of a closely held business seeks a way to motivate and compensate long-service employees.

Generally an ESOP is established and the plan purchases company stock, usually over an extended period. These purchases may be financed by bank borrowing and/or by tax-deductible contributions from corporate profits. With an ESOP, the employees acquire "beneficial ownership," although the employees do not normally acquire management control of the company. The benefits are generally distributed to an employee upon retirement, disability, or death.

The ESOP thus provides a vehicle for the controlled sale of a closely held business (or other private firm), either gradually or all at once, whichever suits the needs of the particular organization. Ideally, it inspires increased loyalty and commitment to the company among the employees plus higher productivity. It is "their company."

All stock and cash acquired by the ESOP is allocated to the accounts of the participating employees—normally in proportion to their annual compensation. These allocations are held for the employees in a trust established under a written agreement. Generally the vesting benefit of an employee is determined by a vesting schedule. Like most employee benefit plans, an ESOP should be structured to benefit those employees who have remained with the firm the longest and who have contributed most to its success.

In companies with younger or middle-age owners/managers, the ESOP will ordinarily acquire 10%-30% of the stock. However, older owner-managers looking toward retirement may be willing to offer a greater share of the ownership and its benefits.

Notably the largest risk to an ESOP is the emerging liability that will come due when terminated or retired participants (or their estates) wish to sell their shares. This liability can be especially burdensome if several long-time senior managers who were also major stockholders decide to cash out within a short span of time. In the planning, then, it is wise to maintain either a conservative balance sheet (good liquidity) or to provide for the segregated sinking fund to cover this liability.

FIRMS THAT SHOULDN'T ADOPT ESOPS

The following kinds of firms should generally **not** adopt an ESOP.

- A company that has no management or business continuation plan.
- A company with only a limited future due to the nature of its product line, geographic location, or management team.
- A company which is subject to major cyclical variations in profitability.

SALE TO OUTSIDER

Chapter 4 considered the hypothetical example of John Talbot, the founder of the Talbot Packaging Company, a company with gross sales of approximately $5,500,000 and 25 employees, including five key managers. The founder, John Talbot, has received a number of unsolicited offers from persons interested in buying the company.

In the Talbot example or for a similarly situated owner of a closely held business, it may be appropriate to take steps to **position** the company for a future sale. If the estate planning concept includes the family eventually selling the business, then an appropriate business strategy must be pursued. Such a strategy could be designed to better develop a management team so that the business is more "saleable"; or to reduce debt, to diversify the customer base; or simply to shape the business so that it is better suited for sale. If the business owns real estate, it may be appropriate to distribute the real estate to the owners (with the contemplation of a sale of the operating business but not of the real estate).

The accountant should play a key role in assisting the owner of a closely held business to identify possible future buyers and to design the necessary financial and business steps to position the company for future sale.

SALE TO INSIDER

DEFECTIVE GRANTOR TRUST

For clients making a large gift in trust for a child (or grandchild), the usual strategy is to structure the trust as an irrevocable trust with the following characteristics:

- The assets in the trust are removed from the estate of the parent-transferor.
- The parent-transferor is not considered the "owner" for estate tax purposes.
- The income of the irrevocable trust is not considered income of the parent-transferor.
  - The parent-transferor is not considered the "owner" for income tax purposes.

EXAMPLE 6–6:

- Father established an irrevocable trust for his son and transferred a rental property with a value of $550,000 which yielded annual net rental income of $35,000.
- The trust provided mandatory distribution of income to the son and the distribution of principal to the son and the son's descendants for health, support, maintenance and education.
- Upon the son's death, the remaining trust principal will pass to the son's descendants, by representation. The son is the sole trustee.
- In the usual mode, the $35,000 of annual income would be part of the gross income of the son, reported on the son's Form 1040.
  - The son would owe the associated income tax of approximately $8,000 to $14,000.

Restructuring Trust

The planner may want to structure the irrevocable trust so that the parent-transferor (and not the son) is considered the "owner" of the income for federal income tax purposes. Section 675 provides, for example, that the grantor (parent-transferor) shall be treated as the owner of any portion of a trust in respect of which:

> A power exercisable by the grantor (parent-transferor) enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security.

Similarly, another power under §675 is the power to reacquire the trust property by substituting other property of equivalent value that is exercisable in a non-fiduciary capacity without the approval or consent of any trustee. If the grantor retains such a power, then the grantor is treated as the owner for income tax purposes.

In essence, an irrevocable gift trust may be structured so that the parent-transferor is considered the "owner" (grantor) for federal income tax purposes. This can be accomplished by attributing one of the administrative powers under §675 to the grantor (parent-transferor).

Effectively, this enables the transferor to make an **additional gift** each year without using any of the annual exclusion or unified credit protection. The transferor is paying what otherwise would be a legal obligation of the son—the tax due on the income the trust property generates. This payment of the income tax, however, is not treated as a gift for gift tax purposes. Depending on the son's income tax bracket, the father in this example is making a tax-free gift to the son each year of approximately $8,000 to $14,000 without penalty.

This technique—structuring the trust so that the transferor remains the "owner" for income tax purposes and therefore is obligated to pay the associated income tax—may be used with a number of the trust techniques discussed elsewhere in this book including, for example, the irrevocable life insurance trust.

Freezing Technique

The sale of an ownership interest in a closely held business to a defective grantor trust may be a "freezing technique."

EXAMPLE 6–7:

- Assume Jim establishes a defective grantor trust with Will and Derrick as the beneficiaries.
  - It is established as an irrevocable trust.
- Assume Jim sells 75% of the stock in Spectacular Sod to the trust for a fair market value price.
- Jim may also sell one of his well-situated tracts of real property to the trust, again at fair market value.
- The trust may provide consideration to Jim in the form of a promissory note.
- This estate planning transaction has the following elements:
  - The trust owns 75% of the stock in Spectacular Sod.
  - The trust owns the designated tract of real estate.
  - The trust owes a promissory note to Jim.
  - The transaction does not trigger the payment of out-of-pocket income tax by Jim.
    - For income tax purposes, Jim is the "seller."
    - For income tax purposes Jim is the "buyer" (because Jim is considered the "owner" of the trust).
    - From an income tax perspective, Jim is in effect "selling the assets to himself."
  - Jim has a promissory note which will not increase in value.

(continued)

EXAMPLE 6–7 (continued):

- The appreciation in the Spectacular Sod business and the appreciation in the tract of real estate will accrue to the trust (and will not be in Jim's estate for federal estate tax purposes).
  - Effectively, Jim has "frozen" his economic interest and has shifted the future appreciation to the second generation.

SECTION 303 REDEMPTION

Section 303 allows a corporation to make a distribution in redemption of a portion of the stock of a decedent that will not be taxed as a dividend. A §303 partial redemption can provide cash and/or other property from the corporation without resulting in dividend treatment and provide cash for the decedent's shareholder estate to use to pay death taxes and other expenses.

To qualify for a §303 redemption:

- The redeemed stock must be included in the decedent's gross estate for federal estate tax purposes.
- The value for federal estate tax purposes of all stock of the corporation that is included in determining the value of the decedent's gross estate must be more than 35% of the excess of (i) the value of the gross estate over (ii) the sums allowable as deductions under §§2053 and 2054.
- Only an amount equal to the total of the estate and inheritance taxes and associated interest and funeral administration expenses can be redeemed and receive favorable income tax treatment.

A redemption under §303 will qualify for favorable tax treatment only to the extent that the interest of a shareholder whose stock is redeemed is reduced either directly or indirectly through a binding obligation to contribute for the payment of the decedent's administration expenses and the death taxes.

A §303 stock redemption is relatively simple. It may often apply in the estate planning of the owner of a closely held business where the business is passing on to second generation. The anticipation is that that ownership and control of Marvelous Masonry will eventually pass to Tim. In this circumstance, it may be necessary to redeem stock from the estate of the first generation owner (Mike). Observe that Spectacular Sod would not qualify for a §303 redemption; the business represents less than 35% of the substantial estate of Jim and Jane.

A plan to redeem stock under §303 may be combined with a purchase by the corporation of life insurance. Typically this would be a key person policy. The corporation would be the applicant, owner, premium, payor and beneficiary. Upon the death of the senior generation owner, a corporation would use the insurance proceeds to effect the §303 redemption, again avoiding dividend treatment on the distribution from the corporation to the insured-owner-decedent's estate.

Stock of any corporation, including an S corporation, may qualify for redemption under §303.

[The discussion of deferred compensation, the ESOP, and the §303 redemption rely substantially upon *Estate Planning*, Stephan R. Leimberg, et al., editor, 9th Ed. The ESOP discussion also adopted significant material directly from Dickson, C. Buxton, *You've Built a Successful Business, Now What?* (Griffin Publishing 1997).]

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